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## **Econometric notes**

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Greene, W. H. (2008): *Econometric Analysis* (6th edition). Prentice-Hall, Inc. Upper Saddle River, NJ. (Sec. 2, 3, 4, 5, 6.1, 6.2, 6.4, 7.1, 7.2, 8.1, 8.4, 8.5, 8.6, 19.7, App. A).

Johnston, J. (1984): *Econometric Methods* (3rd edition). New York: McGraw-Hill, Inc. Traduzione dall'inglese a cura di

M. Costa e P. Paruolo (1993): *Econometrica* (terza edizione). Milano: Franco Angeli. (Sec. 4, 5, 6; 8.1, 8.2, 8.4, 8.5.1, 8.5.2, 8.5.3, 8.5.4, 8.5.7).

Overview of the linear regression model and ordinary least squares estimation (OLS): algebraic properties, statistical properties of OLS, Gauss-Markov theorem, forecast errors, distribution of linear and quadratic forms, linear restrictions, restricted least squares, t-test, F-test, structural change, specification errors.

Simulation (Monte Carlo) experiments to verify algebraic and statistical properties of OLS.

Law of large numbers, central limit theorem, asymptotic properties of OLS (consistency, asymptotic normality).

Aitken theorem, generalized least squares (GLS), asymptotic properties of feasible GLS, seemingly unrelated regression equations (SURE).

Simultaneous equation models (linear and nonlinear), numerical solution methods (Gauss-Seidel, Jacobi), static solution, dynamic solution, structural form, reduced form, final form, examples of models from the literature (Klein-I model), stochastic simulation.

Identification of linear simultaneous equation models, rank and order conditions; demand-supply model.

Estimation of linear simultaneous equation models, indirect least squares, instrumental variables estimators (consistency, asymptotic variance, choice of the optimal instruments for models that include lagged endogenous variables), limited information methods (two stage least squares 2SLS, LIVE, iterative instrumental variables IIV), full information methods (three stage least squares 3SLS, FIVE, iterative methods and connection with maximum likelihood estimators).

Analysis of reduced form of simultaneous equation models, impact and dynamic multipliers, forecasts, confidence intervals of forecasts and multipliers (using delta-method), long term behaviour.

Likelihood, score, information matrix, Cramér-Rao inequality (multidimensional); maximum likelihood estimation, consistency and asymptotic normality, asymptotic variance-covariance matrix, alternative estimators of the variance-covariance matrix (Hessian, outer products, robust estimator); numerical maximization methods (Newton-Raphson, BHHH, BFGS, DFP); application to linear and nonlinear regression models with AR(1) errors.

## **ELEMENTS OF LINEAR ALGEBRA (for undergraduate students)**

Vettori a  $n$  componenti (o vettori nello spazio a  $n$  dimensioni, o vettori di dimensione  $n \times 1$ , o di dimensione  $n$ ).

Elementi o componenti dei vettori.

Vettore nullo.

Rappresentazione con segmenti orientati (e.g. 2 o 3 dimensioni).

Uguaglianza.

Somma di vettori e rappresentazione grafica.

Vettore opposto.

Differenza di vettori.

Prodotto di vettore con scalare.

Vettori unitari di dimensione  $n \times 1$ .

Prodotto scalare (o interno) di due vettori.

Vettori ortogonali: il prodotto scalare è nullo (esempio grafico a 2 dimensioni).

Combinazione lineare di  $m$  vettori di dimensione  $n \times 1$ : è un vettore di dimensione  $n \times 1$ .

Dipendenza e indipendenza lineare di  $m$  vettori di dimensione  $n \times 1$ .

Se  $m$  vettori sono linearmente dipendenti, posso sempre trovarne uno che è rappresentabile come combinazione lineare degli altri.

Gli  $m$  vettori unitari di dimensione  $m \times 1$  sono linearmente indipendenti (esempio a 2 dimensioni).

Due vettori sono linearmente dipendenti se e solo se hanno la stessa direzione; 3 vettori se e solo se sono complanari.

Se 2 vettori di dimensione  $2 \times 1$  sono linearmente indipendenti, ogni altro vettore di dimensione  $2 \times 1$  è combinazione lineare di questi due (esempio grafico); analogamente a 3 dimensioni, un quarto vettore è sempre combinazione lineare di tre vettori linearmente indipendenti; ecc; in particolare, ogni vettore di dimensione  $m \times 1$  è rappresentabile come combinazione lineare degli  $m$  vettori unitari.

Sottoinsiemi di vettori linearmente indipendenti sono linearmente indipendenti.

I vettori di un insieme che contiene un sottoinsieme di vettori linearmente dipendenti sono linearmente dipendenti.

Se in un insieme di  $m$  vettori (con le stesse dimensioni) si possono trovare al massimo  $k < m$  vettori linearmente indipendenti, ogni altro vettore dell'insieme è combinazione lineare di questi  $k$ .

Matrici rettangolari (di dimensioni  $m \times n$ ).

I vettori come matrici con una sola colonna.

Indici di riga e di colonna.

Notazione per le righe ( $A_i$ ) e le colonne ( $A_j$ ).

Matrice nulla.

Uguaglianza di due matrici.

Prodotto di una matrice per uno scalare.

Somma, differenza e combinazione lineare di matrici con le stesse dimensioni.

Prodotto righe per colonne di due matrici e compatibilità delle dimensioni: se la prima ha dimensioni  $m \times n$  e la seconda  $n \times k$ , la matrice prodotto ha dimensioni  $m \times k$ .

La riga  $i$ -esima di  $AB$  si ottiene moltiplicando la riga  $i$ -esima di  $A$  per la matrice  $B$ :  $[AB]_i = A_i.B$ . La colonna  $j$ -esima di  $AB$  si ottiene moltiplicando la matrice  $A$  per la colonna  $j$ -esima di  $B$ :  $[AB]_{.j} = AB_{.j}$ .

Il prodotto è associativo e distributivo rispetto alla somma.

Il prodotto di due matrici non è commutativo (con esempi: per le diverse dimensioni, ma anche per matrici quadrate); si parla di pre- e post-moltiplicazione di una matrice per un'altra.

Matrici quadrate ( $n \times n$ ).

Matrice unitaria, o identica, o identità ( $I$ , o  $I_n$ ).

Matrice diagonale.

Matrice scalare.

Matrice trasposta e vettore trasposto.

Il prodotto scalare (o interno) di due vettori  $(a, b)$  come caso particolare di prodotto di matrici, usando il concetto di vettore trasposto  $(a'b)$ .

Il prodotto esterno di due vettori  $(ab')$  è una matrice.

Matrice (quadrata) simmetrica.

Il prodotto di una matrice, anche se rettangolare, per la sua trasposta è una matrice quadrata simmetrica:  $A'A$  e  $AA'$  sono quadrate simmetriche.

Trasposta della somma di matrici.

Trasposta del prodotto di matrici (dimostrazione per 2, poi per 3 o più di 3).

Se  $b$  è un vettore,  $Ab$  è un vettore colonna;  $b'A$  è una riga;  $Ab$  è una combinazione lineare delle colonne della matrice  $A$ , i cui coefficienti sono gli elementi del vettore  $b$ ;  $b'A$  è una riga, combinazione lineare delle righe della matrice  $A$ .

Permutazioni di  $n$  oggetti.

Fattoriale di  $n$  ( $n!$ ).

Permutazione fondamentale e numero di inversioni.

Classe di una permutazione (pari o dispari).

Scambiando due termini la permutazione cambia classe (si dimostra prima per due termini consecutivi, poi per due termini qualsiasi).

Prodotto associato ad una matrice quadrata.

Definizione di determinante di una matrice quadrata come somma degli  $n!$  prodotti associati alla matrice.

Determinante della matrice trasposta.

Scambiando due colonne o due righe il determinante cambia segno.

Se due righe o colonne sono uguali, il determinante è zero.

Se si moltiplica una riga o colonna per uno scalare, il determinante risulta moltiplicato per lo scalare.

Se una riga (o colonna) è esprimibile come somma di due vettori riga (o colonna), il determinante è uguale alla somma dei determinanti di due matrici.

Se una riga (o colonna) è la somma di due altre righe (o colonne) della stessa matrice, il determinante è zero.

Se una riga (o colonna) è uguale a una combinazione lineare di due o più righe (o colonne) della stessa matrice, il determinante è zero.

Il determinante della somma di due matrici non è la somma dei determinanti.

Se si moltiplica l'intera matrice per uno scalare, il determinante risulta moltiplicato per lo scalare elevato alla  $n$  (e.g. la matrice opposta si ottiene moltiplicando per  $-1$ , per cui il determinante rimane uguale o cambia segno a seconda che  $n$  sia pari o dispari).

Complementi algebrici (o aggiunti, o cofattori).

Espansione del determinante mediante cofattori: è uguale al prodotto scalare di una riga o colonna con i corrispondenti cofattori (solo cenni di dimostrazione).

Il prodotto scalare di una riga (o colonna) con i cofattori di un'altra riga (o colonna) è zero.

Matrice aggiunta: è la trasposta della matrice dei cofattori.

Pre- o post-moltiplicando una matrice quadrata per la sua aggiunta si ottiene una matrice scalare (con gli elementi diagonali uguali al determinante).

Matrice singolare (determinante = 0).

Inversa di una matrice non singolare (ne esiste almeno una, e si ottiene dividendo l'aggiunta per il determinante).

Se  $c$  è un'inversa, è unica.

Inversa del prodotto di due o più matrici quadrate non singolari.

Determinante del prodotto righe per colonne di due matrici quadrate di uguali dimensioni (solo cenni di dimostrazione).

Determinante dell'inversa.

Determinante di una matrice diagonale.

Inversa di una matrice diagonale.

Risoluzione di un sistema lineare di  $n$  equazioni in  $n$  incognite.

In un sistema omogeneo, se la matrice dei coefficienti non è singolare l'unica soluzione è il vettore nullo; affinché possano esserci altre soluzioni occorre che la matrice sia singolare; se la matrice è singolare, ci sono altre soluzioni (senza dimostrazione).

In una matrice singolare le righe (e le colonne) sono linearmente dipendenti.

Sottomatrici quadrate (di matrici rettangolari o quadrate) e minori.

Matrici partizionate.

Matrice rettangolare diagonale a blocchi.

Somma di matrici partizionate (uguali dimensioni delle matrici e uguali dimensioni dei blocchi corrispondenti): si sommano i blocchi corrispondenti.

Matrice quadrata  $A$  ( $n \times n$ ) partizionata in 4 blocchi, di cui quelli diagonali  $A_{1,1}$  ( $n_1 \times n_1$ ) e  $A_{2,2}$  ( $n_2 \times n_2$ ) quadrati (con  $n_1 + n_2 = n$ ), mentre quelli non diagonali  $A_{1,2}$  ( $n_1 \times n_2$ ) e  $A_{2,1}$  ( $n_2 \times n_1$ ) non sono necessariamente quadrati; se una matrice  $B$  ( $n \times n$ ) viene partizionata in modo analogo, la matrice prodotto  $AB$  ( $n \times n$ ) può essere partizionata in modo analogo ad  $A$  e  $B$ ; il blocco 1, 1 della matrice prodotto vale  $(AB)_{1,1} = A_{1,1}B_{1,1} + A_{1,2}B_{2,1}$ ; il blocco 1, 2 vale  $(AB)_{1,2} = A_{1,1}B_{2,1} + A_{1,2}B_{2,2}$ , eccetera; si applicano cioè ai blocchi le stesse regole del prodotto righe per colonne.

La regola precedente vale anche per il prodotto di matrici rettangolari partizionate, purché le matrici siano di dimensioni compatibili, e i blocchi siano di dimensioni compatibili.

Se  $X$  è una matrice (rettangolare o quadrata) diagonale a blocchi,  $X'X$  è una matrice quadrata diagonale a blocchi, con blocchi diagonali quadrati.

Inversa di una matrice quadrata  $A$  partizionata in quattro blocchi, di cui  $A_{1,1}$  e  $A_{2,2}$  quadrati; si indica con  $B$  la matrice inversa  $B = A^{-1}$ , e la si partiziona in maniera analoga; i quattro blocchi della matrice inversa valgono:  $B_{1,1} = (A_{1,1} - A_{1,2}A_{2,2}^{-1}A_{2,1})^{-1}$ ;  $B_{2,2} = (A_{2,2} - A_{2,1}A_{1,1}^{-1}A_{1,2})^{-1}$ ;  $B_{1,2} = -A_{1,1}^{-1}A_{1,2}B_{2,2}$ ;  $B_{2,1} = -A_{2,2}^{-1}A_{2,1}B_{1,1}$ ; sviluppando il prodotto delle due matrici partizionate, si verifica che  $AB = I$ .

Caso particolare: se la matrice è diagonale a blocchi (e i due blocchi diagonali sono quadrati), l'inversa è diagonale a blocchi; i blocchi diagonali dell'inversa sono gli inversi dei corrispondenti blocchi diagonali della matrice data; per la dimostrazione, basta osservare che  $A_{1,2} = 0$  e  $A_{2,1} = 0$ ; questa proprietà vale anche per matrici diagonali a blocchi con tre o più blocchi diagonali; per la dimostrazione, basta considerare la matrice come se fosse partizionata con due blocchi diagonali, ognuno dei quali eventualmente partizionato come una matrice diagonale a blocchi.

Autovalori, o radici caratteristiche, o radici latenti di una matrice quadrata; autovettori, o vettori caratteristici, o vettori latenti corrispondenti; equazione caratteristica.

Autovalori e autovettori di una matrice quadrata reale possono essere reali o complessi (coniugati); ad autovalori reali corrispondono autovettori reali.

L'autovettore che corrisponde ad un certo autovalore non è definito in modo univoco; ad esempio, è certamente definito a meno di una costante moltiplicativa, nel qual caso è definita la direzione, ma non la lunghezza; nel caso di autovalori con molteplicità maggiore di uno non è definita in modo univoco nemmeno la direzione (ad esempio, per la matrice  $I$ , i cui autovalori sono tutti uguali a uno, qualsiasi vettore è autovettore, dunque l'autovettore non è definito univocamente nemmeno in direzione).

Una matrice quadrata simmetrica  $n \times n$  ha  $n$  autovalori (distinti o multipli).

Una matrice quadrata simmetrica ha solo autovalori e autovettori reali.

In una matrice quadrata simmetrica, ad autovalori distinti corrispondono autovettori ortogonali.

In una matrice quadrata simmetrica, se un autovalore ha molteplicità  $k$ , esistono  $k$  autovettori ortogonali tra loro, corrispondenti a tale autovalore (senza dimostrazione).

Una matrice quadrata simmetrica  $n \times n$ , con autovalori non necessariamente distinti, ha  $n$  autovettori tra loro ortogonali; normalizzando ogni autovettore (lunghezza 1) si ottengono  $n$  autovettori ortonormali; questi  $n$  autovettori possono essere ordinati nelle colonne di una matrice quadrata  $Q$ , di ordine  $n$ , che gode della seguente proprietà:  $Q'Q = I$ , quindi  $Q' = Q^{-1}$ , quindi anche  $QQ' = I$ , quindi anche i vettori riga della matrice  $Q$  sono  $n$  vettori ortonormali.

Matrice ortogonale.

In una matrice ortogonale il determinante vale 1 o  $-1$ .

Se  $A$  è una matrice quadrata simmetrica, la matrice ortogonale degli autovettori diagonalizza  $A$ , cioè  $Q'AQ = \Lambda$ , dove  $\Lambda$  è la matrice diagonale degli  $n$  autovalori.

In una matrice quadrata simmetrica, il determinante è il prodotto degli autovalori.

Se  $A$  è una matrice quadrata simmetrica, gli autovalori di  $A^2 = AA$  sono i quadrati degli autovalori di  $A$ , mentre gli autovettori di  $A^2$  sono gli stessi di  $A$ .

Se  $A$  è una matrice quadrata simmetrica non singolare, gli autovalori di  $A^{-1}$  sono i reciproci degli autovalori di  $A$ , mentre gli autovettori di  $A^{-1}$  sono gli stessi di  $A$ .

Minore diverso da zero di ordine massimo.

Rango (limitarsi, negli esempi, al caso di una matrice rettangolare  $X$  con più righe che colonne).

Se  $X$  ha dimensioni  $n \times k$ , con  $k < n$ , il rango sarà  $\leq k$ ; se  $r(X) = k$ ,  $X$  è di rango pieno.

Una matrice quadrata non singolare ha rango pieno.

Se  $r(X) = k$  ( $X$  ha rango pieno), nella sottomatrice non singolare di ordine massimo ( $k \times k$ ) nessuna colonna è combinazione lineare delle altre, dunque non lo è nessuna neppure nell'intera matrice  $X$ .

Se  $r(X) < k$  le colonne sono linearmente dipendenti (senza dimostrazione).

Se  $r(X) = m < k$ ,  $m$  è il massimo numero di colonne linearmente indipendenti (senza dimostrazione);  $m$  è anche il massimo numero di righe linearmente indipendenti (senza dimostrazione).

$r(X'X) = r(XX') = r(X)$ ; se  $X$  ha rango pieno  $= k$  ( $k < n$ ), anche  $X'X$  ha rango pieno ( $= k$ ), ma non  $XX'$  (che ha rango  $k$ , ma dimensioni  $n \times n$ ) (senza dimostrazione).

$r(AB)$  è minore o uguale sia a  $r(A)$  che a  $r(B)$  (senza dimostrazione).

Se  $B$  è una matrice quadrata non singolare, allora  $r(AB) = r(A)$ ; infatti  $r(AB) \leq r(A)$  e  $r(A) = r[(AB)B^{-1}] \leq r(AB)$ .

Il rango di una matrice quadrata simmetrica è uguale al numero degli autovalori diversi da zero.

Traccia di una matrice quadrata.

$Tr(AB) = Tr(BA)$  (se  $A$  e  $B$  hanno dimensioni compatibili per fare entrambi i prodotti).

La traccia di una matrice quadrata simmetrica è uguale alla somma degli autovalori.

Matrice simmetrica idempotente.

Esempi di matrici simmetriche idempotenti e calcolo della traccia: le matrici  $0$ ,  $I$ ,  $A = I - \iota\iota'/n$ , le matrici di proiezione  $P_x = X(X'X)^{-1}X'$ ,  $M_x = I - P_x = I - X(X'X)^{-1}X'$ .

Impiego delle matrici  $A$ ,  $P_x$  e  $M_x$ : se  $y$  è un vettore,  $Ay$  è il vettore degli scarti degli elementi di  $y$  dalla loro media aritmetica ( $Ay = y - \bar{y}$ );  $P_x y$  è il vettore proiezione di  $y$  sul piano (iperpiano) definito dalle colonne della matrice  $X$  (esempio con  $X$  formata da due colonne; prima si prende come vettore  $y$  una delle due colonne di  $X$ , poi si prende un vettore del piano, poi si prende un vettore  $y$  generico, scomponendolo nella somma di un vettore sul piano e di uno ortogonale);  $M_x y = y - P_x y$ , cioè è la proiezione del vettore  $y$  sulla retta perpendicolare al piano (iperpiano) definito dalle colonne di  $X$ .

In una matrice quadrata simmetrica idempotente gli autovalori valgono 0 o 1; il rango è quindi uguale alla traccia.

Forme quadratiche.

Matrici quadrate definite positive e semidefinite positive.

$A'A$  e  $AA'$  sono sempre matrici simmetriche definite o semidefinite positive, per qualsiasi matrice  $A$ .

Date due matrici quadrate di uguali dimensioni, si dice che la prima è maggiore della seconda se la differenza è una matrice non nulla e semidefinita positiva.

Se  $A$  è simmetrica e definita positiva, tutti gli autovalori sono positivi; basta ricordare che  $\Lambda = Q'AQ$ , dunque ogni autovalore (elemento diagonale di  $\Lambda$ ) si ottiene da una forma quadratica dove la matrice ( $A$ ) è definita positiva.

L'inversa di una matrice definita positiva è definita positiva (gli autovalori sono tutti positivi).

Se  $P$  ha dimensioni  $m \times n$ , con  $n \leq m$ , e  $r(P) = n$  (rango pieno), allora  $P'P$  (quadrata  $n \times n$ ) è definita positiva (dato un qualsiasi vettore  $c$  non nullo, è sicuramente positiva la forma quadratica  $c'P'Pc = (Pc)'Pc$ , dove  $Pc$  non è mai il vettore nullo); se  $A$  è simmetrica e definita positiva,  $P'AP$  è simmetrica e definita positiva.

In particolare, se  $P$  è quadrata e non singolare (rango pieno), allora  $P'P$  e  $PP'$  sono definite positive.

Se  $A$  è simmetrica e definita positiva, allora esiste sempre almeno una matrice quadrata di rango pieno  $P$  (non necessariamente simmetrica) tale che  $A = P'P$ ; caso particolare semplice,  $A$  diagonale con elementi tutti positivi.

Vettore delle derivate prime di una funzione scalare rispetto al vettore delle variabili (gradiente); casi particolari: derivare un prodotto scalare rispetto a uno dei due vettori  $\partial(x'y)/\partial x = y$ ,  $\partial(x'y)/\partial y = x$ ; derivare la forma quadratica  $x'Ax$  rispetto al vettore  $x$ :  $\partial(x'Ax)/\partial x = (A + A')x$ .

Matrice delle derivate prime di un vettore di funzioni rispetto al vettore delle variabili (Jacobiano); caso particolare  $\partial(Bx)/\partial x' = B$ .

Matrice delle derivate seconde di una funzione scalare rispetto a un vettore di variabili (Hessiano): caso particolare: derivare due volte la forma quadratica  $x'Ax$  rispetto al vettore  $x$ :  $\partial^2(x'Ax)/\partial x \partial x' = A + A'$  (che è sempre una matrice simmetrica).  
Massimi e minimi di funzioni di più variabili: gradiente zero e Hessiano definito negativo o positivo.

Massimi e minimi vincolati; vettore dei moltiplicatori di Lagrange.

## ELEMENTS OF STATISTICAL ANALYSIS (for undergraduate students)

Probabilità e variabili casuali discrete.

Media (valore atteso), varianza (scarto quadratico medio) e deviazione standard di una variabile casuale discreta.

La media e la varianza di una variabile casuale non sono variabili casuali.

Una funzione di una variabile casuale è una nuova variabile casuale.

Media e varianza di una funzione di variabile casuale (stessa formula, ma con la variabile sostituita dalla funzione).

Una funzione di più variabili casuali è una nuova variabile casuale.

La varianza è sempre positiva; è nulla per una variabile casuale degenere.

La varianza è uguale alla media del quadrato meno il quadrato della media.

Media del prodotto di una variabile casuale per una costante.

Media della somma di due variabili casuali.

Media di una combinazione lineare di due o più variabili casuali: è la combinazione lineare delle medie (la media è un operatore lineare).

Varianza del prodotto di una variabile casuale per una costante:  $Var(ax)$  è uguale al quadrato di  $a$  moltiplicato per la varianza di  $x$ .

Se  $k$  è una costante,  $Var(x) = Var(x - k)$ ; in particolare  $Var(x) = Var[x - E(x)]$ .

Variabile casuale continua.

Ripartizione (distribuzione cumulata) e densità di probabilità.

Media, varianza (scarto quadratico medio) e deviazione standard di una variabile casuale continua.

Variabili casuali bivariate e multivariate discrete.

Variabili casuali bivariate e multivariate continue.

Densità di probabilità per variabili casuali continue bivariate e multivariate (densità di probabilità congiunta).

Densità di probabilità marginale.

Densità di probabilità condizionata.

La densità congiunta è il prodotto di una marginale con una condizionata.

Variabili casuali indipendenti: le densità di probabilità marginali e condizionate sono uguali; la densità congiunta è il prodotto delle due (o più) densità marginali.

Medie e varianze di una variabile casuale multivariata (discreta o continua): si ricavano dalle densità marginali.

Covarianza tra due variabili casuali:  $Cov(x, y)$ .

La covarianza non è una variabile casuale.

$Cov(x, y) = Cov(y, x)$ .

La covarianza è uguale alla media del prodotto meno il prodotto delle medie:  $Cov(x, y) = E(xy) - E(x)E(y)$ .

Se  $a$  e  $b$  sono costanti,  $Cov(ax, y) = Cov(x, ay) = aCov(x, y)$  e  $Cov(ax, by) = abCov(x, y)$ .

Media del prodotto di due variabili casuali: è uguale al prodotto delle due medie più la covarianza.

In una variabile casuale multivariata, le covarianze si riferiscono a coppie di componenti.

Una covarianza può essere positiva, negativa o nulla.

Correlazione (o coefficiente di correlazione) tra due variabili casuali: è il rapporto tra la covarianza e la radice quadrata del prodotto delle due varianze.

Il coefficiente di correlazione è compreso fra  $-1$  e  $1$ .

Due variabili casuali si dicono incorrelate quando la covarianza (e quindi anche la correlazione) è zero.

Variabili casuali indipendenti sono incorrelate; non è detto il viceversa, cioè variabili casuali incorrelate non sono necessariamente indipendenti (lo sono sicuramente se sono componenti di una normale multivariata).

La media del prodotto di due variabili casuali incorrelate è uguale al prodotto delle medie (la covarianza infatti è zero).

Funzioni di variabili casuali indipendenti sono indipendenti (e quindi incorrelate); funzioni di variabili incorrelate possono essere correlate.

Le  $n$  componenti  $X_1, X_2, \dots, X_n$  di una variabile casuale  $n$ -variata,  $x$ , (o le  $n$  variabili casuali  $X_1, X_2, \dots, X_n$ ) possono essere rappresentate mediante un vettore di  $n$ -componenti, detto vettore casuale, o vettore di variabili casuali.

Vettore delle medie o vettore medio:  $E(x)$ .

Matrice di varianze e covarianze di un vettore di variabili casuali  $x$ :  $\Sigma = Var(x) = E\{[(x - E(x))[x' - E(x')]]\}$ . Se  $a$  è un vettore non casuale,  $E(a'x) = a'E(x)$ , poiché si tratta della media di una combinazione lineare.

$Var(a'x) = a'Var(x)a$ .

La matrice di varianze e covarianze di un vettore casuale non degenere è simmetrica (poiché  $Cov(x, y) = Cov(y, x)$ ) e definita positiva: infatti se  $a$  è un vettore non casuale con le stesse dimensioni di  $x$ ,  $a'Var(x)a$  è la varianza della variabile casuale scalare (o unidimensionale)  $a'x$ , ed è dunque sempre positiva (purché  $a$  non sia il vettore nullo).

Se  $A$  è una matrice non casuale (e di dimensioni opportune),  $E(Ax) = AE(x)$ ; inoltre  $Var(Ax) = AVar(x)A'$ .

La matrice di varianze e covarianze di variabili casuali incorrelate è una matrice diagonale; se tali variabili hanno la stessa varianza, la matrice è scalare.

La distribuzione uniforme discreta e continua.

La somma di due o più variabili casuali uniformi non ha distribuzione uniforme.

La distribuzione normale.

La formula della funzione di densità di probabilità definisce una famiglia di distribuzioni a due parametri; a conti fatti, i due parametri sono la media e la varianza (o la deviazione standard) della variabile casuale normale.

La probabilità di estrarre un valore compreso tra meno e più una deviazione standard è circa  $2/3$  (o 66%); tra meno e più due deviazioni standard è circa il 95%.

Una variabile casuale normale con media zero e varianza uno è detta normale standard; nella formula della densità di probabilità non compaiono più i due parametri (media e varianza).

Ogni variabile casuale normale si trasforma in una normale standard sottraendole la media e dividendo per la deviazione standard.

La tabella relativa alla normale standard riporta i valori delle probabilità in corrispondenza ai valori della variabile casuale; si noti che la distribuzione è simmetrica attorno allo zero.

La distribuzione normale multivariata; nella formula della funzione di densità di probabilità compaiono il vettore delle medie e la matrice di varianze e covarianze.

Ogni combinazione lineare (con coefficienti non casuali) di variabili casuali normali (univariate o multivariate) è una variabile casuale normale (univariata o multivariata); questa è una proprietà caratteristica delle variabili casuali con distribuzione normale; ad esempio se  $x$  è un vettore  $N(m, \Sigma)$ , allora  $Ax$  è un vettore  $N(Am, A\Sigma A')$ .

La distribuzione  $\chi^2$ .

Sommando i quadrati di  $n$  variabili casuali normali standard indipendenti si ottiene una variabile casuale la cui distribuzione è detta  $\chi^2$  con  $n$  gradi di libertà:  $\chi_n^2$ .

Il  $\chi^2$  è una famiglia di distribuzioni ad un parametro ( $n$ , il numero di gradi di libertà).

La media di una variabile casuale  $\chi^2$  con  $n$  gradi di libertà è uguale a  $n$ ; la varianza vale  $2n$ .

La tabella relativa alla famiglia di distribuzioni  $\chi^2$  riporta, per ogni valore dei gradi di libertà (una riga) i valori della variabile casuale corrispondenti ad alcuni valori particolari della probabilità: 0.99, 0.98, 0.95, ..., 0.01; si tratta dei valori critici comunemente impiegati nei test di ipotesi; si noti che la distribuzione non è simmetrica.

La distribuzione  $t$ -di-Student.

Siano date due variabili casuali indipendenti, la prima delle quali con distribuzione normale standard, la seconda con distribuzione  $\chi^2$  con  $n$  gradi di libertà; il rapporto tra la prima e la radice quadrata della seconda preventivamente divisa per  $n$  è una variabile casuale la cui distribuzione è detta  $t$ -di-Student con  $n$  gradi di libertà:  $t_n$ .

La  $t$ -di-Student è una famiglia di distribuzioni a un parametro ( $n$ , il numero di gradi di libertà).

La distribuzione è simmetrica attorno allo zero.

All'aumentare del numero di gradi di libertà la funzione di densità di una variabile casuale  $t$ -di-Student si avvicina sempre più alla funzione di densità di probabilità di una normale standard.

Quando il numero di gradi di libertà non è abbastanza grande, i valori della variabile casuale corrispondenti a probabilità 0.10, 0.05, ecc. sono tabulati.

La distribuzione  $F$ -di-Fisher.

Siano date due variabili casuali con distribuzione  $\chi^2$ , indipendenti, rispettivamente con  $n$  e  $k$  gradi di libertà; il rapporto tra la prima, preventivamente divisa per  $n$ , e la seconda, preventivamente divisa per  $k$ , è una variabile casuale la cui distribuzione è detta  $F$ -di-Fisher con  $n, k$  gradi di libertà.

La  $F$ -di-Fisher è una famiglia di distribuzioni a due parametri ( $n$  e  $k$ , i numeri di gradi di libertà).

Le tabelle riportano, al variare dei gradi di libertà, i valori critici della variabile più comunemente impiegati nei test (probabilità 1%, 5%).

## **MULTIPLE LINEAR REGRESSION MODEL** (the simple linear regression as a particular case)

### **The assumptions of the multiple linear regression model**

(1) A dependent or explained variable (also called regressand) is assumed to be a linear combination of some independent or explanatory variables (or regressors); the relationship is not exact, as it includes an additive error term (or unexplained disturbance); dependent variable and regressors are observable, and measured without errors; the coefficients of the linear combination are “fixed constants” (they are not random variables), but are unknown; the error terms are random variables and are not observable; the vector containing the  $n$  observations of the dependent variable ( $y_1, y_2, \dots, y_i, \dots, y_n$ ) is called  $y$  ( $n \times 1$ ); the  $n$  observations of the  $k$  explanatory variables are assembled in a matrix  $X$  ( $n \times k$ ); if the model includes the intercept, matrix  $X$  has a column whose elements are all ones; the  $k$  coefficients of the linear combination are assembled in a vector  $\beta$  ( $k \times 1$ ); the vector  $u$  ( $n \times 1$ ) contains the error terms; the multiple linear regression model is represented as:  $y = X\beta + u$ ; each element is  $y_i = x'_i\beta + u_i$ , being  $x'_i$  the  $i$ -th row of  $X$ .

(2) Matrix  $X$  has full column rank:  $r(X) = k$ , that is all columns of  $X$  are linearly independent; this implies, in particular,  $n \geq k$ ; in other words, the number of observations (or sample size) cannot be smaller than the number of regressors (in practice, interest is confined to the case where strictly  $n > k$ ).

(3) The expectation of all the error terms is zero:  $E(u) = 0$ .

(4) The error terms are uncorrelated (all covariances are zero) and homoskedastic (the variance of each error, called  $\sigma^2$ , is constant, but unknown):  $Var(u_1) = Var(u_2) = \sigma^2$ , etc;  $Cov(u_1, u_2) = 0$ , etc;  $E(uu') = \sigma^2 I_n$  (scalar variance-covariance matrix).

(5) The contents of matrix  $X$  are known constants (non-random variables); since  $E(u) = 0$ , one gets  $E(y) = X\beta$ ; the expected value (or “conditional” expected value) of each  $y_i$  is always a point on the regression line (or plane, or hyperplane).

(6) The vector of error terms  $u$  has a multivariate normal distribution; thus, combining assumption 6 with assumptions 3 and 4,  $u$  is distributed  $N(0, \sigma^2 I_n)$ .

The estimation method called “ordinary least squares” (OLS) provides an estimate of the unknown parameters of the model (coefficients  $\beta$  and variance  $\sigma^2$ ); its algebraic properties are based on assumptions 1 and 2 (other assumptions being unnecessary); some statistical properties of the OLS estimation method are based on assumptions 1-5; finally, some other statistical properties need all assumptions (1-6).

### **OLS: algebraic properties** (under assumptions 1-2)

Given a vector of coefficients  $\beta$ , the corresponding vector of “residuals” can be obtained as  $u = y - X\beta$ , thus each residual can be represented as a function of the variables  $y$  and  $X$  (observed) and coefficients ( $\beta$ , unknown); we look for the vector of coefficients (called  $\hat{\beta}$ ) that minimize the sum of all squared residuals; the method is called OLS (ordinary least squares), and coefficients computed in this way are the OLS estimates of the regression coefficients (simply: OLS coefficients).

Under assumptions 1 and 2, OLS coefficients are available in closed form as  $\hat{\beta} = (X'X)^{-1}X'y$ ; this expression is obtained equating to zero the first order derivatives of the sum of squared residuals with respect to the  $k$  coefficients  $\beta$  (first order conditions); it can then be verified that the  $(k \times k)$  matrix of second order derivatives (Hessian) is positive definite (second order condition).

The vector that contains the computed values (or fitted values) of the dependent variable is  $\hat{y} = X\hat{\beta}$ .

The vector of OLS residuals is the difference between the vector of observed values and the vector of computed values of the dependent variable (computed with OLS coefficients):  $\hat{u} = y - \hat{y} = y - X\hat{\beta} = y - X(X'X)^{-1}X'y = M_x y = M_x u$ , where  $M_x$  is the idempotent symmetric matrix (or projection matrix)  $M_x = I_n - X(X'X)^{-1}X'$ , whose trace (=rank) is  $n - k$ .

If the number of observations (or sample size) is equal to the number of explanatory variables  $n = k$  (instead of  $n > k$ ),  $X$  would be a square matrix, thus  $(X'X)^{-1} = X^{-1}(X')^{-1}$ , thus  $M_x = 0$ , thus  $\hat{u} = 0$ ; in other words, all the points of the sample would lie on the regression line (or plane, or hyperplane).

The vector of OLS residuals is orthogonal to each explanatory variable (or regressor):  $X'\hat{u} = 0$ ; with different words, one can say that OLS residuals are uncorrelated in the sample with each regressor.

The vector of OLS residuals is orthogonal to the vector of computed value of the dependent variable:  $\hat{y}'\hat{u} = 0$ .

If the regression model includes the intercept, then the matrix of regressors includes a column whose values are all ones (a constant regressor); thus the sum of residuals is zero; if the model is without intercept, the sum of OLS residuals may be nonzero.

In particular, in a simple linear regression model with intercept  $y = \beta_1 + \beta_2 z + u$ , the point with coordinates  $(\bar{z}, \bar{y})$ , arithmetical averages) is on the regression line estimated by OLS; measuring variables  $y_i$  and  $z_i$  as deviations from their arithmetical averages is like shifting the origin of the Cartesian axes over the point  $(\bar{z}, \bar{y})$ ; thus an OLS estimation of the model without intercept  $y_i - \bar{y} = \beta_2(z_i - \bar{z}) + u$  would produce the same value  $\hat{\beta}_2$  and the same residuals  $\hat{u}$  as the OLS estimation of the original model (with intercept).

Coefficient of determination ( $R^2$ ) for the model with intercept: it is a measure of the fit of the model (for the model without intercept the definition should be slightly modified; not done here).

Defining  $A$  as the symmetric idempotent matrix that produces deviations from the arithmetical average,  $A = I_n - u'u/n$ , the sum of squares of the deviations of the  $y_i$  from their arithmetical average is:  $TSS = (Ay)'Ay = y'Ay$  (total sum of squares).  $ESS = \hat{y}'A\hat{y}$  = sum of squares of the deviations of the  $\hat{y}_i$  from their arithmetical average (explained sum of squares).

$RSS = \hat{u}'\hat{u}$  = residual sum of squares (remembering that residuals have arithmetical average zero).

In the model with intercept,  $TSS = ESS + RSS$ ; to prove it, from  $y = \hat{y} + \hat{u}$ , pre-multiplication by  $A$  gives  $Ay = A\hat{y} + \hat{u}$ , then transposition of this expression and multiplication by the expression itself gives  $y'Ay = \hat{y}'A\hat{y} + \hat{u}'\hat{u}$  (the cross products are zero because  $\hat{u}$  is orthogonal to  $\hat{y}$ , and  $A\hat{u} = \hat{u}$  because the model has the intercept).

The coefficient of determination is defined as  $R^2 = ESS/TSS = 1 - RSS/TSS$ .

The sample correlation coefficient between  $y$  and  $\hat{y}$  is  $\sqrt{R^2}$ ; the proof follows from observing that the sample variances of  $y$  and  $\hat{y}$  are, respectively,  $TSS/n$  and  $ESS/n$ , and the sample covariance is  $(Ay)'(A\hat{y})/n = (A\hat{y} + \hat{u})'(A\hat{y})/n = ESS/n$ .

$R^2$  in the model with intercept is a number between 0 and 1.

$R^2 = 0$  means “no fit”;  $R^2 = 1$  means “perfect fit”; as a rough indicator of goodness of fit; usually, the larger the  $R^2$ , the better the fit; a remarkable exception is when  $k = 1$  and the only regressor is the constant (all values = 1), so that  $\hat{\beta} = \bar{y}$ ; thus  $TSS = RSS$ , thus  $R^2 = 0$ , even if the fit is good.

Adding new explanatory variables to the same equation necessarily improves the  $R^2$  (that cannot decrease); intuitively, if the additional regressors are “meaningful”, the improvement will be large, but if they are meaningless the improvement will be small or even null; it is possible to define an “adjusted”  $R^2$ , that takes into account the reduction of degrees of freedom due to the introduction of new regressors:  $1 - [RSS/(n - k)]/[TSS/(n - 1)]$ ; it might become smaller after the introduction of a new regressor without explanatory power.

**OLS: some statistical properties** (under assumptions 1-5; valid even without intercept)

The vector of estimated coefficients is a random vector (unlike the “true” coefficients vector  $\beta$ , which is a nonrandom vector).

The vector of coefficients estimation errors is  $\hat{\beta} - \beta = (X'X)^{-1}X'u$ .

Under assumptions 1-5 (6 is unnecessary), OLS estimator is linear and unbiased.

Under assumptions 1-5, the variance-covariance matrix of the OLS coefficients is  $(X'X)^{-1}\sigma^2$ .

Gauss-Markov theorem: Under assumptions 1-5 (6 is unnecessary), OLS coefficients have the smallest variance-covariance matrix, among all linear unbiased estimators; thus, OLS estimator is the most efficient linear unbiased estimator.

Proof: any linear estimator of the coefficients vector would be  $B'y$ , where  $B$  is a matrix with the same dimensions of  $X$  and does not contain random variables; defining  $A' = B' - (X'X)^{-1}X'$ , unbiasedness of the estimator is ensured if and only if  $A'X = 0$ ; computing the variance-covariance matrix of the coefficients obtained with the new estimation method, and imposing the unbiasedness constraint  $A'X = 0$ , such a matrix is greater than the OLS coefficients variance-covariance matrix, the difference being  $A'A\sigma^2$  (positive semi-definite).

OLS estimator is BLUE (best linear unbiased estimator).

$RSS = \hat{u}'\hat{u} = u'M_x u$  (even if the model has no intercept); its expected value is  $E(RSS) = E(u'M_x u) = tr[E(u'M_x u)] = E[tr(u'M_x u)] = E[tr(M_x uu')] = tr[E(M_x uu')] = tr[M_x E(uu')] = tr(M_x \sigma^2) = tr(M_x)\sigma^2 = (n - k)\sigma^2$ .

Thus  $E[RSS/(n - k)] = \sigma^2$ ; thus an unbiased estimator of the variance of the error terms is  $\hat{\sigma}^2 = RSS/(n - k)$ .

Summarizing:  $\hat{\sigma}^2 = RSS/(n - k) = \hat{u}'\hat{u}/(n - k) = u'M_x u/(n - k)$ ; its square root ( $\hat{\sigma}$ ) is called “standard error” of the regression.

Since  $X$  does not contain random variables,  $(X'X)^{-1}\hat{\sigma}^2$  is an unbiased estimator of the variance-covariance matrix of the OLS coefficients; the  $j - th$  diagonal element  $[(X'X)^{-1}]_{j,j}\hat{\sigma}^2$  is an unbiased estimator of the variance of the  $j - th$  estimated coefficient ( $\hat{\beta}_j$ ), and its square root is the standard error of  $\hat{\beta}_j$ .

Forecast (or prediction) at time  $h$  (not belonging to the sample estimation period 1, 2, ...,  $n$ ): given the vector of explanatory variables at time  $h$ ,  $x_h$ , assumed known (conditional prediction), the best prediction at time  $h$  of the dependent variable  $y$  would be the expectation (conditional on  $x_h$ ) of  $y$  at time  $h$ , that will be indicated as  $\bar{y}_h = x_h'\beta$ ; if the model is correctly specified the “true” value of  $y$  at time  $h$  will be affected by a random error  $u_h$  and therefore will be  $y_h = x_h'\beta + u_h$ ; being the “true” coefficients  $\beta$  unknown, and being  $\hat{\beta}$  the available estimate, the actual prediction will be the estimated conditional expectation of  $y$  at time  $h$ , that is  $\hat{y}_h = x_h'\hat{\beta}$ ; with a geometric notation, prediction would be the point on the estimated regression line (or plane, or hyperplane) corresponding to  $x_h$ .

Forecast error (or prediction error) at time  $h$ : it is the difference between prediction and the “true” value of  $y$  at time  $h$ , that is  $\hat{y}_h - y_h$ .

Variance of the forecast error (or simply variance of forecast): adding and subtracting the same quantity gives  $\hat{y}_h - y_h = (\hat{y}_h - \bar{y}_h) + (\bar{y}_h - y_h) = x_h'(\hat{\beta} - \beta) - u_h = x_h'(X'X)^{-1}X'u - u_h$ ; it is the sum of two uncorrelated random variables (since the forecast period  $h$  does not belong to the sample estimation period,  $u_h$  is uncorrelated with the  $n$  “in sample” elements



of the vector  $u$ , according to assumption 4), thus the variance is the sum of the two variances; the variance of the second component is  $\sigma^2$  (constant for any  $x_h$ ), while the variance of the first component is  $x_h'(X'X)^{-1}x_h\sigma^2$ , thus it depends on the values of the explanatory variables in the forecast period ( $x_h$ ); in the simple linear regression model, with two variables  $y = \beta_1 + \beta_2 z + u$ , the variance has a minimum when  $z_h$  is equal to the arithmetical average of the elements of  $z$  in the sample, and becomes larger and larger as  $z_h$  moves far away from the average.

**Distribution of linear and quadratic forms** (built from multivariate normal vectors)

- (1) If the random vector  $z$  (whose dimension is  $n \times 1$ ) has a multivariate standard normal distribution  $N(0, I_n)$ , then  $z'z$  has a  $\chi^2$  distribution with  $n$  degrees of freedom ( $\chi_n^2$ ).
- (2) If the vector  $z$  (whose dimension is  $n \times 1$ ) contains  $k < n$  elements  $= 0$ , while the other  $n - k$  elements form a vector  $N(0, I_{n-k})$ , then  $z'z$  has a  $\chi^2$  distribution with  $n - k$  degrees of freedom ( $\chi_{n-k}^2$ ).
- (3) If the random vector  $z$  (whose dimension is  $n \times 1$ ) has a multivariate standard normal distribution  $N(0, I_n)$  and  $A$  is a matrix of constants, with dimensions  $n \times n$ , symmetric, idempotent with rank  $n - k \leq n$ , then the univariate random variable  $z'Az$  has a  $\chi^2$  distribution with  $n - k$  degrees of freedom; the proof is based on the decomposition  $A = Q'\Lambda Q$ , where  $Q$  is an orthogonal matrix ( $Q' = Q^{-1}$ ) and  $\Lambda$  is the diagonal matrix containing the eigenvalues; among eigenvalues, there are  $n - k$  ones, while the others are zeroes; also  $\Lambda$  is idempotent ( $\Lambda\Lambda = \Lambda$ ); the vector  $Qz$  has a multivariate normal distribution  $N(0, I_n)$  (since  $QQ' = I_n$ );  $\Lambda Qz$  is a random vector with  $n$  elements;  $n - k$  elements have a  $N(0, I_{n-k})$  distribution, while the other  $k$  elements are zeroes; finally,  $z'Az = (\Lambda Qz)'\Lambda Qz$  and the results follows from applying (2).
- (4) If the random vector  $x$  (whose dimension is  $n \times 1$ ) has a multivariate normal distribution  $N(0, \Sigma)$ , where  $\Sigma$  is a  $n \times n$  symmetric positive definite matrix, then the univariate random variable  $x'\Sigma^{-1}x$  has a  $\chi^2$  distribution with  $n$  degrees of freedom; to prove it, first  $\Sigma$  must be decomposed as  $\Sigma = P'P$ , where  $P$  is a non-singular square matrix; it follows that  $z = (P')^{-1}x$  has a zero mean multivariate normal distribution with variance-covariance matrix  $(P')^{-1}\Sigma P^{-1} = (P')^{-1}P'PP^{-1} = I_n$ ; thus,  $z$  has a multivariate standard normal distribution, and the result follows from (1).
- (5) If the random vector  $z$  (whose dimension is  $n \times 1$ ) has a multivariate standard normal distribution  $N(0, I_n)$ , if  $A$  and  $B$  are two “constant” matrices with dimensions  $m \times n$  and  $k \times n$  respectively, and their product is  $AB' = 0$  (null matrix), then the two random vectors  $Az$  ( $m \times 1$ ) and  $Bz$  ( $k \times 1$ ) are independent random vectors; to prove it,  $Az$  and  $Bz$  must be regarded as two sub-vectors of a multivariate normal random vector  $[(m + k) \times 1]$ , and the matrix that contains covariances between all the elements of  $Az$  and  $Bz$  is  $AB'$  (thus  $= 0$ ); finally it is enough to remember that uncorrelated elements of a multivariate normal are independent.
- (6) If  $A$ ,  $B$  and  $z$  are as in (5), any transformation of the vector  $Az$  and any transformation of the vector  $Bz$  will produce independent random variables (or vectors).
- (7) If  $A$  and  $B$  are as in (5), and the random vector  $x$  (with dimension  $n \times 1$ ) is distributed  $N(0, \sigma^2 I_n)$ , the random vectors  $Ax$  and  $Bx$  will be independent multinormal random vectors, and any transformation of each of the two vectors will produce independent random variables (or vectors); the proof follows from (5) or (6) simply dividing each vector by the scalar constant  $\sigma$ , and remembering that  $z = x/\sigma$  is  $N(0, I_n)$ .
- (8) As a particular case of (7), if the random vector  $x$  (with dimension  $n \times 1$ ) is distributed  $N(0, \sigma^2 I_n)$ , and  $A$  and  $B$  are both square symmetric idempotent matrices ( $n \times n$ ) such that  $AB = 0$ , then the two quadratic forms  $x'Ax/\sigma^2$  and  $x'Bx/\sigma^2$  are independent scalar random variables; in addition, it follows from (3) that each of the two quadratic forms has a  $\chi^2$  distribution with degrees of freedom equal to the rank (therefore also equal to the trace) of the matrix  $A$  or  $B$ , respectively.

**Statistical inference in the multiple linear regression model** (under assumptions 1-6; also 6 is necessary)

Coefficients estimated by (Gaussian) maximum likelihood are equal to the OLS coefficients, and their variance-covariance matrix is the inverse of Fisher's information matrix (Cramér-Rao bound); remember that Gauss-Markov theorem did not use the assumption of normality, and proved efficiency among “linear unbiased” estimators; here, under the additional assumption of normality (6), OLS is efficient with respect to “any unbiased” estimator (proof, see sect. 18.6).

The vector of coefficient estimation errors  $\hat{\beta} - \beta = (X'X)^{-1}X'u$  is a linear combination of  $u$  (multivariate normal); thus it has a multivariate normal distribution  $N[0, (X'X)^{-1}\sigma^2]$ .

The  $j$ -th estimated coefficient ( $\hat{\beta}_j$ ) has a normal distribution with mean  $\beta_j$  and variance  $[(X'X)^{-1}]_{j,j}\sigma^2$ .

The vector  $u/\sigma$  has a multivariate normal distribution  $N(0, I)$ .

$RSS/\sigma^2 = \hat{u}'\hat{u}/\sigma^2 = (u'/\sigma)M_x(u/\sigma)$ , where  $M_x$  is symmetric, idempotent and its rank is  $n - k$ , is a random variable with distribution  $\chi^2$  with  $(n - k)$  degrees of freedom.

Since  $\hat{\sigma}^2 = RSS/(n - k)$ , then the ratio  $\hat{\sigma}^2/\sigma^2$  is a random variable  $\chi_{n-k}^2$  divided by the number of degrees of freedom  $n - k$ .

The two random vectors  $\hat{\beta} - \beta$  and  $\hat{u}$  are independent, since  $\hat{\beta} - \beta = (X'X)^{-1}X'u$ ,  $\hat{u} = M_x u$ , and the product of the two matrices  $(X'X)^{-1}X'M_x = 0$ .

Any transformation of  $\hat{\beta} - \beta$  and of  $\hat{u}$  will produce independent random variables; in particular,  $\hat{\beta} - \beta$  is independent of  $\hat{\sigma}^2$ .

- (1)  $\hat{\beta}_j - \beta_j$ , divided by the square root of its variance  $[(X'X)^{-1}]_{j,j}\sigma^2$ , is a standard normal random variable.
- (2) If  $R$  is a constant row vector, the scalar variable  $(R\hat{\beta} - R\beta)$  divided by the square root of its variance  $[R(X'X)^{-1}R']\sigma^2$ , is a standard normal random variable.
- (3) The quadratic form  $(\hat{\beta} - \beta)'(X'X/\sigma^2)(\hat{\beta} - \beta)$  is a random variable  $\chi_k^2$ .
- (4) If  $R$  is a constant matrix with dimensions  $(q \times k)$  and rank  $q$ , the quadratic form  $(R\hat{\beta} - R\beta)'[R(X'X)^{-1}R']^{-1}(R\hat{\beta} - R\beta)/\sigma^2$  is a random variable  $\chi_q^2$ ; the proof follows observing that  $R\hat{\beta} - R\beta = R(\hat{\beta} - \beta)$  is a  $q \times 1$  random vector with multivariate normal distribution, zero mean and variance-covariance matrix  $[R(X'X)^{-1}R']\sigma^2$ .

Case (1) is a particular case of (2), obtained when  $R$  is a row vector of all zeroes, but the  $j$ -th element  $= 1$ .

Case (3) is a particular case of (4), obtained when  $R$  is the identity matrix  $k \times k$ .

If  $r$  is a constant vector with dimension  $q \times 1$ , then  $R\beta = r$  is a system of  $q$  linear restrictions (or linear constraints) on the  $k$  coefficients; in particular, if  $q = 1$  (that is matrix  $R$  is a row vector and  $r$  is a scalar constant),  $R\beta = r$  represents “one” linear restriction on coefficients.

Suppose that  $\sigma^2$  is known, then a test of “one” coefficient or a test of “one” linear restriction on coefficients (cases 1 and 2) could be done using the standard normal distribution.

Suppose that  $\sigma^2$  is known, then a test of  $q$  linear restrictions on coefficients (also called multiple restriction, case 4) could be done using the  $\chi_q^2$  distribution; in particular a test of all coefficients (case 3) would use the  $\chi_k^2$  distribution.

Usually  $\sigma^2$  is unknown, and the formulas of cases 1, 2, 3 and 4 can be applied replacing  $\sigma^2$  with its unbiased estimate  $\hat{\sigma}^2$ ; as a consequence, the test statistics that had a standard normal distribution (cases 1 and 2) are now distributed as a Student’s- $t$  with  $n - k$  degrees of freedom; the test statistics that had  $\chi^2$  distributions with  $k$  or  $q$  degrees of freedom (cases 3 and 4) are now distributed as by Fisher’s- $F$  with  $k, n - k$  or  $q, n - k$  degrees of freedom, after the expressions of the test statistics are divided by  $k$  or  $q$ , respectively.

The proof follows observing that, in all cases,  $\sigma^2$  is always at the denominator (under square root in cases 1 and 2); replacing  $\sigma^2$  with  $\hat{\sigma}^2$  is equivalent to multiplying the denominator by the ratio  $\hat{\sigma}^2/\sigma^2$ , that is a random variable  $\chi_{n-k}^2/(n - k)$  (under square root in cases 1 and 2) independent of the numerator; thus, the standard normal will produce a Student’s- $t$  with  $n - k$  degrees of freedom (cases 1 and 2); in case 3, the random variable  $\chi_k^2$  will be divided by an independent random variable  $\chi_{n-k}^2/(n - k)$ , thus a further division by  $k$  will produce a Fisher’s- $F$  with  $k, n - k$  degrees of freedom; in case 4, the random variable  $\chi_q^2$  will be divided by an independent random variable  $\chi_{n-k}^2/(n - k)$ , thus a further division by  $q$  will produce a Fisher’s- $F$  with  $q, n - k$  degrees of freedom.

(1bis)  $(\hat{\beta}_j - \beta_j)/\sqrt{[(X'X)^{-1}]_{j,j}\hat{\sigma}^2}$ , is a random variable with Student’s- $t$  distribution ( $t_{n-k}$ ).

(2bis) If  $R$  is a row vector of constants, the scalar  $(R\hat{\beta} - R\beta)/\sqrt{R(X'X)^{-1}R'\hat{\sigma}^2}$  is a random variable with Student’s- $t$  distribution ( $t_{n-k}$ ).

(3bis) The quadratic form  $(\hat{\beta} - \beta)'[X'X/(k\hat{\sigma}^2)](\hat{\beta} - \beta)$  is a random variable with Fisher’s- $F$  distribution ( $F_{k,n-k}$ ).

(4bis) If  $R$  is a matrix of constants, with dimensions  $(q \times k)$  and rank  $q$ , the quadratic form  $(R\hat{\beta} - R\beta)'[R(X'X)^{-1}R']^{-1}(R\hat{\beta} - R\beta)/(q\hat{\sigma}^2)$  is a random variable with Fisher’s- $F$  distribution ( $F_{q,n-k}$ ).

Examples of tests that use the Student’s- $t$  distribution.

The null hypothesis concerns the exact value of the  $j$ -th coefficient, while the alternative is that such a coefficient has a different value; this is usually written as  $H_0 : \beta_j = r$ ;  $H_1 : \beta_j \neq r$ , where  $r$  is a given constant; under the null hypothesis the ratio between  $(\hat{\beta}_j - r)$  and the standard error of  $\hat{\beta}_j$  will be a random variable with Student’s- $t$  distribution ( $t_{n-k}$ ); as a “default” option, all software packages test the null hypothesis  $\beta_j = 0$ , thus they simply compute the ratio between  $\hat{\beta}_j$  and its standard error; under the null hypothesis such a ratio is a random variable with Student’s- $t$  distribution ( $t_{n-k}$ ); if this ratio (in absolute value) is greater than the critical value (at 5%, for instance), the null hypothesis is rejected in favour of the alternative hypothesis ( $\beta_j \neq 0$ , thus concluding that the  $j$ -th regressor is significant).

The null hypothesis concerns the “equality” of two coefficients, that is  $H_0 : \beta_1 = \beta_2$ ;  $H_1 : \beta_1 \neq \beta_2$ ; the null hypothesis is a linear restriction that can be represented as  $R\beta = r$ , where  $r = 0$  (scalar) and  $R$  is a row vector whose first two elements are 1 and  $-1$ , while all the others are zeroes; then, under the null hypothesis, the ratio between the scalar random variable  $(R\hat{\beta} - r)$  and the square root of  $[R(X'X)^{-1}R']\hat{\sigma}^2$  is a  $t_{n-k}$ ; if this ratio (in absolute value) is greater than the critical value (at 5%, for instance), the null hypothesis is rejected in favour of the alternative hypothesis (thus concluding that the two coefficients are different).

The null hypothesis concerns the “sum” of two coefficients:  $H_0 : \beta_1 + \beta_2 = 1$ ;  $H_1 : \beta_1 + \beta_2 \neq 1$ ; for instance, the exponents of the two production factors in a Cobb-Douglas log-linear function become the coefficients of a linear regression model after variables have been transformed into logarithms, and the constant returns to scale hypothesis has to be tested; the null hypothesis is a linear restriction representable as  $R\beta = r$ , where  $r = 1$  (scalar) and  $R$  is a row vector whose first two elements are 1, while all the others are zeroes; then the procedure is the same as in the previous case.

Examples of tests that use the Fisher’s- $F$  distribution.

If the matrix  $R$  has dimensions  $1 \times k$  (row vector) and its elements are all zeroes with the only exception of the  $j$ -th element, which is 1, then the test statistic is distributed as a  $F(1, n - k)$  and it is exactly equal to the square of the test statistic discussed above (when testing the hypothesis  $\beta_j = 0$ ), which was distributed as a Student’s- $t$  ( $t_{n-k}$ ); the two tests always give the same result, since the critical value (for instance at 5%) of the  $F(1, n - k)$  is exactly the square of the  $t_{n-k}$  critical value.

If  $r$  is a vector of  $k$  zeroes, and  $R$  is the identity matrix with dimensions  $k \times k$ , then the system of linear restrictions  $R\beta = r$  means  $\beta_1 = 0, \beta_2 = 0, \dots, \beta_k = 0$ , and the  $F(k, n - k)$  test statistic is obtained from  $\hat{\beta}'X'X\hat{\beta}/(k\hat{\sigma}^2)$ ; this could be considered a significance test of the whole regression; in fact, the null hypothesis would be accepted if no regressor is significant; in practice, this is done only for linear regressions without intercept.

Significance test for a subset of regressors; the usual procedure is applied using a suitable matrix  $R$  ( $q \times k$ ) with elements zeroes or ones, and a  $(q \times 1)$  vector  $r = 0$ ; as a “default” option for regression models with intercept, software packages test the null hypothesis that “all coefficients but the intercept” are zeroes, and this is the usual significance test of the whole regression.

### Restricted least squares estimation

The method aims at producing coefficient values that minimize the sum of squared residuals satisfying, at the same time,  $q \leq k$  linear restrictions  $R\beta = r$ ;  $\lambda$  indicates a  $q \times 1$  vector of *Lagrange multipliers* and is used to build the *Lagrangean function*:  $f$

$= (y - X\beta)'(y - X\beta) - 2\lambda'(R\beta - r)$  (minus sign and the factor 2 are introduced to simplify computation); estimates of  $\beta$  and  $\lambda$  are the solution of the system of first order conditions, obtained differentiating  $f$  with respect to  $\beta$  and  $\lambda$ ; differentiating with respect to  $\beta$  gives  $\partial f/\partial\beta = -2X'y + 2X'X\beta - 2R'\lambda$ ; differentiating with respect to  $\lambda$  gives  $\partial f/\partial\lambda = -2(R\beta - r)$ ; the first order conditions are obtained equating to zero the two vectors of derivatives: (1)  $X'X\hat{\alpha} - X'y - R'\hat{\lambda} = 0$ ; (2)  $R\hat{\alpha} - r = 0$  (the system (1) and (2) is a system of  $k + q$  linear equations with  $k + q$  unknowns; to avoid confusion with the OLS coefficients of the unrestricted model,  $\hat{\alpha}$  will be used to indicate the solution for coefficients, while  $\hat{\lambda}$  will be the solution for the multipliers); pre-multiplying (1) by  $R(X'X)^{-1}$  gives  $R\hat{\alpha} - R(X'X)^{-1}X'y - R(X'X)^{-1}R'\hat{\lambda} = 0$ , where substitution of  $R\hat{\alpha}$  with  $r$  gives  $r - R\hat{\beta} - R(X'X)^{-1}R'\hat{\lambda} = 0$ , that produces the solution for the vector of Lagrange multipliers  $\hat{\lambda} = [R(X'X)^{-1}R']^{-1}(r - R\hat{\beta})$ ; this expression of  $\hat{\lambda}$  can be substituted into (1) giving  $X'X\hat{\alpha} - X'y - R'[R(X'X)^{-1}R']^{-1}(r - R\hat{\beta}) = 0$ , that provides the solution  $\hat{\alpha} = \hat{\beta} - W(R\hat{\beta} - r)$ , having indicated  $W = (X'X)^{-1}R'[R(X'X)^{-1}R']^{-1}$ .

After estimating coefficients that satisfy the system of linear restrictions,  $\hat{\alpha}$ , the corresponding residuals are  $\hat{e} = y - X\hat{\alpha} = y - X\hat{\beta} - X(\hat{\alpha} - \hat{\beta}) = \hat{u} - X(\hat{\alpha} - \hat{\beta})$  where  $\hat{u}$  is the vector of OLS residuals (unrestricted); pre-multiplication by the transpose gives  $\hat{e}'\hat{e} = \hat{u}'\hat{u} + (\hat{\alpha} - \hat{\beta})'X'X(\hat{\alpha} - \hat{\beta})$  (the cross products vanish, because  $X'\hat{u} = 0$ ); substituting the value of  $\hat{\alpha} - \hat{\beta}$  computed above gives  $\hat{e}'\hat{e} - \hat{u}'\hat{u} = (R\hat{\beta} - r)'[R(X'X)^{-1}R']^{-1}(R\hat{\beta} - r)$ .

The above expression is the difference between the sums of squared residuals in the least squares estimations with restrictions and without restrictions, respectively;  $\hat{e}'\hat{e} = RRSS$  is the restricted residual sum of squares,  $\hat{u}'\hat{u} = URSS$  is the unrestricted residual sum of squares, (obviously the former is always greater or equal to the latter); the explicit formula just obtained for such a difference is equal to the numerator of the Fisher's- $F$  statistic when testing the system of  $q$  linear restrictions  $R\beta = r$  (4bis).

Thus, an alternative expression of the Fisher's- $F$  test statistic can be used:  $[(RRSS - URSS)/q]/[URSS/(n - k)]$ , where  $RRSS$  is the restricted residual sum of squares (that is, after restrictions have been imposed to the model),  $URSS$  is the unrestricted residual sum of squares (the model estimated by OLS, without imposing any restriction),  $q$  is the number of restrictions; the denominator, as above, is the OLS unbiased estimate of the variance of the unrestricted model:  $\hat{\sigma}^2 = URSS/(n - k)$ ; obviously, it is always  $RRSS \geq URSS$ , so that the value cannot be negative.

The above alternative expression of the Fisher's- $F$  test statistic can always be applied when testing a set of linear restrictions  $R\beta = r$ ; instead of estimating by OLS the unrestricted model, and then applying the formula (4bis), the alternative procedure needs two OLS estimations, one of the original model (unrestricted) and one of the model after restrictions have been imposed (restricted model);  $URSS$  and  $RRSS$  are computed from the two set of residuals.

When restrictions produce a model whose OLS estimation is simple (in other words, when restricted least squares can be performed easily) the alternative procedure can be easier than the application of the formulas (3bis and 4bis); it does not lead to a simplification when restricted least squares is of difficult application.

As a "default" option for regression models with intercept ( $\beta_1$ ), software packages test the null hypothesis that "all coefficients but the intercept" are zeroes, and this is the usual significance test of the whole regression, that is  $H_0 : \beta_2 = 0, \beta_3 = 0, \dots, \beta_k = 0$ ; thus the number of restrictions is  $q = k - 1$ , and the alternative expression of the Fisher's- $F$  is quite simple; the restricted model has a unique regressor (the constant), thus its coefficient is the arithmetical average of the dependent variable; thus  $RRSS$  is the sum of squared deviations of the observed elements of  $y$  from their arithmetical average (called  $TSS$ , when dealing with the definition of  $R^2$ ); therefore in this particular case the computation of the  $F_{k-1, n-k}$  test statistic is quite similar to the computation of the  $R^2$  (in particular, the  $R^2$  adjusted for the degrees of freedom); a value of the test statistic greater than the critical value (for instance at 5%) of the  $F_{k-1, n-k}$  distribution leads to rejection of the null hypothesis, thus accepting some sort of significance of the whole regression.

Other cases where it is simple to estimate the restricted least squares coefficients (thus the alternative form of the Fisher's- $F$  test statistic is of simple computation): when the null hypothesis is  $\beta_1 = \beta_2$ , or  $\beta_1 + \beta_2 = 0$ , or  $\beta_1 + \beta_2 = 1$ , or the hypothesis concerns a structure of *distributed lags* where weights decrease linearly.

Expected values of coefficients estimated by restricted least squares: since  $\hat{\alpha} = \hat{\beta} - W(R\hat{\beta} - r)$ , it is  $E(\hat{\alpha}) = E(\hat{\beta}) - W(RE(\hat{\beta}) - r) = \beta - W(R\beta - r)$ ; thus, if the restrictions are "valid" so that  $R\beta - r = 0$ , the consequence is  $E(\hat{\alpha}) = \beta$ , thus estimation is unbiased; on the contrary, if restrictions are not valid,  $R\beta - r \neq 0$  and the restricted least squares estimates are usually biased, the bias being  $E(\hat{\alpha}) - \beta = -W(R\beta - r)$ .

The variance-covariance matrix of coefficients estimated by restricted least squares is  $Var(\hat{\alpha}) = Var[\hat{\beta} - W(R\hat{\beta} - r)] = Var(\hat{\beta} - WR\hat{\beta}) = Var[(I - WR)\hat{\beta}] = (I - WR)(X'X)^{-1}(I - WR)'\sigma^2 = (X'X)^{-1}\sigma^2 - WR(X'X)^{-1}\sigma^2 - (X'X)^{-1}R'W'\sigma^2 + WR(X'X)^{-1}R'W'\sigma^2$  (when  $W$  is replaced by its full expression, two terms will cancel out)  $= (X'X)^{-1}\sigma^2 - (X'X)^{-1}R'[R(X'X)^{-1}R']^{-1}R(X'X)^{-1}\sigma^2$ ; thus it is equal to the variance-covariance matrix of OLS coefficients "minus" a symmetric positive semidefinite matrix; thus restricted least squares coefficients always have a variance-covariance matrix smaller than (at most equal to) the unrestricted OLS coefficients, no matter if restrictions are valid (thus the restricted estimate is unbiased) or not valid (thus the restricted estimate is usually biased); it must be noticed that the vector  $r$  does not appear in the expression of this matrix.

Specification error due to omission of relevant explanatory variables: let  $X = [X_1, X_2]$ , but instead of the correctly specified model  $y = X_1\beta_1 + X_2\beta_2 + u$ , with  $k = k_1 + k_2$  regressors, the model that is estimated is  $y = X_1\alpha_1 + e$ , with  $k_1$  regressors, omitting  $k_2$  relevant regressors ( $X_2$ ); it is like estimating the original model with restricted least squares, after imposing the restrictions  $\beta_2 = 0$ , which are not valid; thus there will usually be a bias in the estimated coefficients; explicit computation gives  $E(\hat{\alpha}_1) = E[(X_1'X_1)^{-1}X_1'y] = E[(X_1'X_1)^{-1}X_1'(X_1\beta_1 + X_2\beta_2 + u)] = \beta_1 + (X_1'X_1)^{-1}X_1'X_2\beta_2$ ; thus, bias depends, among other things, on the omitted variables and coefficients ( $X_2\beta_2$ ); however, in a particular case the restricted estimate might be unbiased for the included coefficients: when the omitted regressors are orthogonal to the included regressors, that is when

$X_1'X_2 = 0$ ; also the estimate of the variance is biased (overestimated); in fact  $\hat{\sigma}^2 = (\hat{e}'\hat{e})/(n - k_1) = (y'M_{X_1}y)/(n - k_1) = (X_1\beta_1 + X_2\beta_2 + u)'M_{X_1}(X_1\beta_1 + X_2\beta_2 + u)/(n - k_1) = (X_2\beta_2 + u)'M_{X_1}(X_2\beta_2 + u)/(n - k_1)$  (being  $M_{X_1}X_1 = 0$ ), and its expectation is  $E(\hat{\sigma}^2) = \sigma^2 + \beta_2'X_2'M_{X_1}X_2\beta_2/(n - k_1)$ ; this systematic overestimation occurs also when the omitted regressors are orthogonal to the included regressors: in fact, if  $X_1'X_2 = 0$ , the expected value is  $\sigma^2 + \beta_2'X_2'X_2\beta_2/(n - k_1)$ .

Specification error due to the inclusion of irrelevant explanatory variables (regressors that do not help explanation of the dependent variable): the correctly specified model is  $y = X_1\beta_1 + e$ , but OLS estimation is applied to a model that includes additional regressors,  $X_2$ , which are not relevant; this is like saying that the “unrestricted” model  $y = X_1\beta_1 + X_2\beta_2 + u$  is correctly specified, with “true” values of the  $\beta_2$  coefficients = 0; thus OLS estimation of the unrestricted model is unbiased (in particular with  $E(\hat{\beta}_2) = 0$ ); the original model,  $y = X_1\beta_1 + e$ , can be viewed as obtained from the unrestricted model imposing the set of “valid” restrictions  $\beta_2 = 0$ , so OLS estimation is also unbiased and, having imposed restrictions, it has a variance-covariance matrix smaller than the unrestricted OLS coefficients; thus, including some irrelevant explanatory variables on the right hand side of the equation does not produce any bias, but reduces efficiency.

Test of structural change (also called Chow test): in a linear regression model, where the sample size is  $n$ , a change in the structure may have occurred; it is possible that the coefficients in the first sub-sample ( $n_1$  observations) are different from coefficients in the second sub-sample ( $n_2$  observations, where  $n_1 + n_2 = n$ ); the null hypothesis to be tested is that coefficients remained constant over the whole sample; vector  $y$  ( $n$  elements) is divided into the two sub-vectors  $y_1$  e  $y_2$ , corresponding to the two sub-samples of the dependent variable; analogously, the matrix of regressors is divided into the two sub-matrices  $X_1$  ( $n_1 \times k$ ) and  $X_2$  ( $n_2 \times k$ ) and two vectors of coefficients are considered,  $\beta_1$  and  $\beta_2$ , both  $k \times 1$ ; the coefficients vector  $\beta$  ( $2k \times 1$ ) contains the elements of  $\beta_1$  followed by the elements of  $\beta_2$ ; matrix  $X$  ( $n \times 2k$ ) is a block-diagonal matrix whose diagonal blocks are  $X_1$  and  $X_2$ , while off-diagonal blocks contain all zeroes; OLS estimation is applied to the model  $y = X\beta + u$ ; the coefficients in the vector  $\hat{\beta}$  ( $2k \times 1$ ) are exactly the same that would be obtained from two separate OLS estimations of the model  $y_1 = X_1\beta_1 + u_1$  using the first  $n_1$  observations, and the model  $y_2 = X_2\beta_2 + u_2$  on the last  $n_2$  observations (the proof is straightforward, remembering that  $X'X$  is a block-diagonal square matrix, thus it can be inverted simply inverting the two diagonal blocks that are  $X_1'X_1$  and  $X_2'X_2$ ); the sum of the  $n$  squared residuals is  $URSS$ ; the null hypothesis is that  $\beta_1 = \beta_2$  (no structural change); this test is based on the Fisher’s- $F$  distribution and is usually applied using the alternative form of the test; so it is now necessary to estimate the model after imposing the  $k$  linear restrictions (or constraints)  $\beta_1 = \beta_2$ ; the restricted model has a matrix of regressors  $X$  ( $n \times k$ ) where  $X_1$  and  $X_2$  are two consecutive blocks (rather than diagonal blocks), and has a vector of coefficients  $\beta$  containing  $k$  elements; this restricted model  $y = X\beta + u$  is estimated by OLS on the whole sample period ( $n$  observations) computing  $RRSS$  as the sum of  $n$  squared residuals; it must be noticed that the unrestricted model has  $2k$  regressors, and that the restricted model is obtained imposing  $k$  restrictions; thus the Fisher’s- $F$  test statistic ( $k, n - 2k$ ) is obtained as  $[(RRSS - URSS)/k]/[URSS/(n - 2k)]$ ; a value of the test statistic greater than the critical value (for instance at 5%) of the  $F_{k, n-2k}$  distribution leads to rejection of the null hypothesis (that coefficients did not change in the two sub-samples), thus evidencing a structural change.

The test of structural change can be applied to a subset of coefficients; this can be done in the unrestricted model by “duplicating” only the coefficients that might change in the sample, and splitting the corresponding regressors, while the other regressors and coefficients remain unchanged; the degrees of freedom of the Fisher’s- $F$  depend on the number of coefficients that are tested; for instance, when testing only one coefficient, the degrees of freedom of the Fisher’s- $F$  will be  $1, n - k - 1$  (1 restriction,  $k$  regressors in the original model,  $k + 1$  regressors in the unrestricted model, after the split of one column into two columns).

The test of structural change can be applied also when two or more changes may have occurred in the sample; for instance it is possible that all coefficients have changed their values when passing from the first sub-sample ( $n_1$  observations) to the second sub-sample ( $n_2$  observations) and again to the third sub-sample ( $n_3$  observations, where  $n_1 + n_2 + n_3 = n$ ); the unrestricted model will have a block-diagonal matrix of regressors with 3 diagonal blocks (its dimensions will be  $n \times 3k$ ), and a  $(3k \times 1)$  vector of coefficients.

*Remark.* Estimation of the unrestricted model would be impossible if the block-diagonal matrix  $X'X$  is singular; this happens if one of the sub-periods has a number of observations  $< k$  (insufficient observations); for instance, if  $n_2 < k$ ,  $X_2'X_2$  is singular, so  $X'X$  cannot be inverted, being  $X_2'X_2$  its second diagonal block; a solution to this problem is the Chow predictive test, that estimates the restricted model on the longer sub-sample, uses it to predict the shorter sub-period, and finally considers the distribution of the prediction error.

### Multiple linear regression model where the variance-covariance matrix is not scalar and it is “known”

(4-bis) If assumption (4) is not valid, the variance-covariance matrix of the error terms is represented as  $E(uu') = \sigma^2\Omega$ , where  $\Omega$  ( $n \times n$ ) is symmetric and positive definite; OLS estimation is unbiased, since  $E(\hat{\beta} - \beta) = E[(X'X)^{-1}X'u] = 0$ ; the variance-covariance matrix of the OLS coefficients is  $(X'X)^{-1}X'\Omega X(X'X)^{-1}\sigma^2$ ; if assumption (4) is not valid, Gauss-Markov may be not applicable; thus OLS may be inefficient.

Aitken’s theorem: under assumptions 1, 2, 3, 4-bis and 5 (6 is unnecessary), if  $\Omega$  is known (that is, the variance-covariance matrix is almost completely known, the only unknown being a scalar multiplicative constant called  $\sigma^2$ ), coefficient estimated by generalized least squares (GLS)  $\hat{\beta} = (X'\Omega^{-1}X)^{-1}X'\Omega^{-1}y$  have the smallest variance-covariance matrix among all linear unbiased estimators; in other words, GLS is efficient with respect to any other linear unbiased estimator.

The proof follows from a straightforward application of Gauss-Markov theorem to an appropriate transformation of the model; first of all the GLS estimator is unbiased because  $E(\hat{\beta} - \beta) = (X'\Omega^{-1}X)^{-1}X'\Omega^{-1}u = 0$ , and its variance-covariance matrix is  $(X'\Omega^{-1}X)^{-1}\sigma^2$ ; to prove efficiency, first of all matrix  $\Omega$  must be decomposed as  $\Omega = P'P$ , where  $P$  is a non-singular square matrix ( $n \times n$ ); the model is then transformed pre-multiplying by  $P'^{-1}$ , which gives  $P'^{-1}y = P'^{-1}X\beta + P'^{-1}u$ ; the

transformed variables are now called  $q = P'^{-1}y$ ,  $Q = P'^{-1}X$  and the transformed error terms are called  $\varepsilon = P'^{-1}u$ ; the transformed variable are thus related through the linear regression model  $q = Q\beta + \varepsilon$ , where coefficients are the same as in the original model, and the error terms are such that  $E(\varepsilon) = 0$ ,  $E(\varepsilon\varepsilon') = P'^{-1}E(uu')P^{-1} = P'^{-1}\Omega P^{-1}\sigma^2 = \sigma^2 I$ ; thus the transformed model satisfies all the conditions underlying Gauss-Markov theorem, thus OLS is efficient when it is applied to the transformed model (instead of the original model), which gives:  $\hat{\beta} = (Q'Q)^{-1}Q'q = (X'P^{-1}P'^{-1}X)^{-1}X'P^{-1}P'^{-1}y = (X'\Omega^{-1}X)^{-1}X'\Omega^{-1}y$ , which is the GLS estimation of the original model.

*Remark.* The result does not change if, in the final GLS formula, the whole expression of the variance-covariance matrix  $\sigma^2\Omega$  is used instead of  $\Omega$  (the scalar constant  $\sigma^2$  would cancel out).

### A list of other topics

Dummy variables.

Regression specification error test (Reset).

Heteroskedastic errors: OLS is unbiased but not efficient; heteroskedasticity of “known” form and weighted least squares; Breusch and Pagan test; heteroskedasticity of “unknown” form and “sandwich” estimator of the variance-covariance matrix; White’s test.

Autocorrelated errors: OLS is unbiased but not efficient; first order autoregressive errors AR(1); Cochrane-Orcutt estimation method; Durbin-Watson test and tables of the critical values; Breusch and Godfrey test (LM test or Fisher’s- $F$  test); optimal prediction when errors are AR(1).

Multicollinearity; perfect and near multicollinearity.

# 1 OBVIOUS AND BANAL MATTERS - Ma con voi non si sa mai.....

## 1.1 Products of matrices and vectors

$$X' = \begin{matrix} (k \times n) \\ \begin{bmatrix} x_{1,1} & x_{2,1} & \dots & x_{i,1} & \dots & x_{n,1} \\ x_{1,2} & x_{2,2} & \dots & x_{i,2} & \dots & x_{n,2} \\ \dots & \dots & \dots & \dots & \dots & \dots \\ x_{1,k} & x_{2,k} & \dots & x_{i,k} & \dots & x_{n,k} \end{bmatrix} \end{matrix}$$

$$X = \begin{matrix} (n \times k) \\ \begin{bmatrix} x_{1,1} & x_{1,2} & \dots & x_{1,k} \\ x_{2,1} & x_{2,2} & \dots & x_{2,k} \\ \dots & \dots & \dots & \dots \\ x_{i,1} & x_{i,2} & \dots & x_{i,k} \\ \dots & \dots & \dots & \dots \\ x_{n,1} & x_{n,2} & \dots & x_{n,k} \end{bmatrix} \end{matrix}$$

$$u = \begin{matrix} (n \times 1) \\ \begin{bmatrix} u_1 \\ u_2 \\ \dots \\ u_i \\ \dots \\ u_n \end{bmatrix} \end{matrix}$$

$$x_i = \begin{matrix} (k \times 1) \\ \begin{bmatrix} x_{i,1} \\ x_{i,2} \\ \dots \\ x_{i,k} \end{bmatrix} \end{matrix} = \text{column } i \text{ of } X'$$

$$x'_i = \begin{matrix} (1 \times k) \\ [x_{i,1} \quad x_{i,2} \quad \dots \quad x_{i,k}] \end{matrix} = \text{row } i \text{ of } X$$

$$u_i = \text{is a scalar}$$

There are  $n$  matrices  $x_i x'_i$  of dimensions  $(k \times k)$ .

$X'X = \sum_{i=1}^n x_i x'_i$  is the matrix  $(k \times k)$  *sum* of these  $n$  matrices.

$\frac{1}{n} X'X = \frac{1}{n} \sum_{i=1}^n x_i x'_i$  is the matrix  $(k \times k)$  *arithmetical average* of these  $n$  matrices.

There are  $n$  vectors  $x_i u_i$  of dimensions  $(k \times 1)$ .

$X'u = \sum_{i=1}^n x_i u_i$  is the vector  $(k \times 1)$  *sum* of these  $n$  vectors.

$\frac{1}{n} X'u = \frac{1}{n} \sum_{i=1}^n x_i u_i$  is the vector  $(k \times 1)$  *arithmetical average* of these  $n$  vectors.

$$W' = \begin{matrix} (k \times n) \\ \begin{bmatrix} w_{1,1} & w_{2,1} & \dots & w_{i,1} & \dots & w_{n,1} \\ w_{1,2} & w_{2,2} & \dots & w_{i,2} & \dots & w_{n,2} \\ \dots & \dots & \dots & \dots & \dots & \dots \\ w_{1,k} & w_{2,k} & \dots & w_{i,k} & \dots & w_{n,k} \end{bmatrix} \end{matrix}$$

$$W = \begin{matrix} (n \times k) \\ \begin{bmatrix} w_{1,1} & w_{1,2} & \dots & w_{1,k} \\ w_{2,1} & w_{2,2} & \dots & w_{2,k} \\ \dots & \dots & \dots & \dots \\ w_{i,1} & w_{i,2} & \dots & w_{i,k} \\ \dots & \dots & \dots & \dots \\ w_{n,1} & w_{n,2} & \dots & w_{n,k} \end{bmatrix} \end{matrix}$$

$$w_i = \begin{matrix} (k \times 1) \\ \begin{bmatrix} w_{i,1} \\ w_{i,2} \\ \dots \\ w_{i,k} \end{bmatrix} \end{matrix} = \text{column } i \text{ of } W'$$

$$w'_i = \begin{matrix} (1 \times k) \\ [w_{i,1} \quad w_{i,2} \quad \dots \quad w_{i,k}] \end{matrix} = \text{row } i \text{ of } W$$

There are  $n$  matrices  $w_i x'_i$  of dimensions  $(k \times k)$ .

$W'X = \sum_{i=1}^n w_i x'_i$  is the matrix  $(k \times k)$  *sum* of these  $n$  matrices.

$\frac{1}{n} W'X = \frac{1}{n} \sum_{i=1}^n w_i x'_i$  is the matrix  $(k \times k)$  *arithmetical average* of these  $n$  matrices.

There are  $n$  vectors  $w_i u_i$  of dimensions  $(k \times 1)$ .

$W'u = \sum_{i=1}^n w_i u_i$  is the vector  $(k \times 1)$  *sum* of these  $n$  vectors.

$\frac{1}{n} W'u = \frac{1}{n} \sum_{i=1}^n w_i u_i$  is the vector  $(k \times 1)$  *arithmetical average* of these  $n$  vectors.

## 1.2 Quadratic forms and rectangular forms

If  $u$  is a  $(n \times 1)$  vector and  $A$  is a  $(n \times n)$  matrix, the quadratic form has the following scalar expression:

$$u' A u = \sum_{i=1}^n \sum_{j=1}^n a_{i,j} u_i u_j$$

If  $v$  is a  $(k \times 1)$  vector and  $B$  is a  $(n \times k)$  matrix, the rectangular form has the following scalar expression:

$$u' B v = \sum_{i=1}^n \sum_{j=1}^k b_{i,j} u_i v_j$$

## 1.3 A special product of three matrices

If  $X$  is a  $(n \times k)$  matrix as above, and  $\Sigma$  is a  $(n \times n)$  diagonal matrix

$$\Sigma = \begin{matrix} (n \times n) \\ \begin{bmatrix} \sigma_1^2 & 0 & \dots & 0 & \dots & 0 \\ 0 & \sigma_2^2 & \dots & 0 & \dots & 0 \\ \dots & \dots & \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & \sigma_i^2 & \dots & 0 \\ \dots & \dots & \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & 0 & \dots & \sigma_n^2 \end{bmatrix} \end{matrix}$$

then  $X' \Sigma X = \sum_{i=1}^n x_i x'_i \sigma_i^2$

## 1.4 Schwarz inequality

Between scalars, with scalar notation:  $(\sum_{i=1}^n a_i b_i)^2 \leq (\sum_{i=1}^n a_i^2) (\sum_{i=1}^n b_i^2)$

Between scalars, with vector notation (if  $a'b \neq 0$ ):  $(a'b)^2 \leq (a'a) (b'b) \Rightarrow (a'b)^{-1} a'a (b'a)^{-1} \geq (b'b)^{-1}$

It is a particular case of the following inequality between positive semidefinite matrices (with dimensions of  $X$  and  $W$  as above, and provided  $n \geq k$  and  $W'X$  is non-singular):  $(W'X)^{-1}W'W(X'W)^{-1} \geq (X'X)^{-1}$

Proof:  $(W'X)^{-1}W'W(X'W)^{-1} - (X'X)^{-1} = [(W'X)^{-1}W' - (X'X)^{-1}X'] [(W'X)^{-1}W' - (X'X)^{-1}X']'$ , being the product of a matrix with its transpose, is a positive semidefinite matrix.

## 2 AN EXAMPLE OF SIMULTANEOUS EQUATIONS: KLEIN-I MODEL

The *structural form* of the model is

$$\begin{cases} C_t = \alpha_1 + \alpha_2 P_t + \alpha_3 P_{t-1} + \alpha_4 W_t + u_{1,t} & \text{Consumption} \\ I_t = \alpha_5 + \alpha_6 P_t + \alpha_7 P_{t-1} + \alpha_8 K_{t-1} + u_{2,t} & \text{Investment (net)} \\ W_t^p = \alpha_9 + \alpha_{10} X_t + \alpha_{11} X_{t-1} + \alpha_{12} A_t + u_{3,t} & \text{Private wages} \\ X_t = C_t + I_t + G_t & \text{Equilibrium demand} \\ P_t = X_t - T_t - W_t^p & \text{Profits} \\ K_t = K_{t-1} + I_t & \text{Capital stock} \\ W_t = W_t^p + W_t^g. & \text{Total wages} \end{cases} \quad (2.1)$$

The model is usually presented as a system of 6 equations with 6 endogenous variables, as it was originally proposed in Klein (1950). The last (seventh) equation and endogenous variable, introduced here in addition to the original 6, avoids the need of equality restrictions in the first equation (otherwise the coefficient  $\alpha_4$  would multiply the sum of two variables  $W_t^p + W_t^g$ ). Also, the third and fourth equations are usually presented in a slightly different way; the representation adopted here (2.1), taken from Greene (2008, 15.2), is perfectly equivalent to the original, but can be treated more easily.

This is an excellent example of a small, linear and manageable macroeconomic dynamic model, widely used in the literature as a test ground for estimation methods. The original Klein's data set contains data of the U.S. economy from 1920 to 1941 (interwar years, including the *depression* years; all variables are *at constant prices*). Due to the lag-1 variables, the estimation period (or sample period) is 1921-1941.

Endogenous variables are the 7 variables appearing on the left hand side of each structural equation, labeled on the right. The 5 exogenous variables are: 1 = Constant;  $W_t^g$  = Government wages;  $T_t$  = Business taxes;  $A_t$  = Linear time trend, measured as annual deviations from 1931 (positive or negative; it is used as a *proxy* for increased union strength during the sample period);  $G_t$  = Government nonwage expenditure.

The model also includes 3 lagged endogenous variables ( $X_{t-1}, P_{t-1}, K_{t-1}$ ).

The model contains 3 behavioural stochastic equations (the first 3 equations) and 4 identities, the first of which is an equilibrium condition, while the last three equations are accounting (or definitional) identities.

No variable appears in the model with an order lag greater than one; also there are no lagged exogenous variables (in any case, higher order lags and lagged exogenous could be easily treated by *augmenting* the vector of endogenous variables and including appropriate definitional identities).

The original data set and detailed numerical results are in Appendix (15).

## 3 SIMULTANEOUS EQUATIONS: STRUCTURAL FORM AND REDUCED FORM

*Structural form* and *reduced form* of a system of simultaneous equations can be represented as

$$\begin{cases} \text{Structural form} \\ By_t + \Gamma z_t = u_t \\ u_t : i.i.d. \\ E(u_t) = 0 \\ Var(u_t) = \Sigma \end{cases} \quad \begin{cases} \text{Reduced form} \\ y_t = \Pi z_t + v_t \\ v_t : i.i.d. \\ E(v_t) = 0 \\ Var(v_t) = \Psi \end{cases} \quad (3.2)$$

This representation makes no difference between exogenous and lagged endogenous variables. It is used to study identification, estimation, and solution of the model *one step ahead*. The  $(G \times 1)$  vector of endogenous variables at time  $t$  is called  $y_t$  ( $7 \times 1$  in the example);  $z_t$  is the  $(K \times 1)$  vector of exogenous and lagged endogenous variables at time  $t$  ( $8 \times 1$  in the example);  $u_t$  and  $v_t$  are the  $(G \times 1)$  vectors of error terms at time  $t$ ,  $\Sigma$  and  $\Psi$  their variance-covariance matrices (constant  $\forall t$ ).

With reference to the model used as example it is

$$\begin{aligned} y_t = \begin{bmatrix} C_t \\ I_t \\ W_t^p \\ X_t \\ P_t \\ K_t \\ W_t \end{bmatrix} \quad (G \times 1) \quad (7 \times 1) \quad z_t = \begin{bmatrix} 1 \\ W_t^g \\ T_t \\ A_t \\ G_t \\ X_{t-1} \\ P_{t-1} \\ K_{t-1} \end{bmatrix} \quad (K \times 1) \quad (8 \times 1) \quad u_t = \begin{bmatrix} u_{1,t} \\ u_{2,t} \\ u_{3,t} \\ 0 \\ 0 \\ 0 \\ 0 \end{bmatrix} \quad (G \times 1) \quad (7 \times 1) \quad v_t = \begin{bmatrix} v_{1,t} \\ v_{2,t} \\ v_{3,t} \\ v_{4,t} \\ v_{5,t} \\ v_{6,t} \\ v_{7,t} \end{bmatrix} \quad (G \times 1) \quad (7 \times 1) \end{aligned} \quad (3.3)$$

$B$  is the  $(G \times G)$  matrix of structural form coefficients of the endogenous variables ( $7 \times 7$  in the example);  $\Gamma$  is the  $(G \times K)$  matrix of structural form coefficients of the exogenous and lagged endogenous variables ( $7 \times 8$  in the example).

$$B = \begin{matrix} (G \times G) \\ (7 \times 7) \end{matrix} \begin{bmatrix} 1 & 0 & 0 & 0 & -\alpha_2 & 0 & -\alpha_4 \\ 0 & 1 & 0 & 0 & -\alpha_6 & 0 & 0 \\ 0 & 0 & 1 & -\alpha_{10} & 0 & 0 & 0 \\ -1 & -1 & 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 1 & -1 & 1 & 0 & 0 \\ 0 & -1 & 0 & 0 & 0 & 1 & 0 \\ 0 & 0 & -1 & 0 & 0 & 0 & 1 \end{bmatrix} \quad \Gamma = \begin{matrix} (G \times K) \\ (7 \times 8) \end{matrix} \begin{bmatrix} -\alpha_1 & 0 & 0 & 0 & 0 & 0 & -\alpha_3 & 0 \\ -\alpha_5 & 0 & 0 & 0 & 0 & 0 & -\alpha_7 & -\alpha_8 \\ -\alpha_9 & 0 & 0 & -\alpha_{12} & 0 & -\alpha_{11} & 0 & 0 \\ 0 & 0 & 0 & 0 & -1 & 0 & 0 & 0 \\ 0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & -1 \\ 0 & -1 & 0 & 0 & 0 & 0 & 0 & 0 \end{bmatrix} \quad (3.4)$$

The vector of error terms in the structural form equations,  $u_t$ , has some elements identically zero (4 in the example), corresponding to the identities. So, the  $(G \times G)$  matrix of variances and covariances of the structural form errors  $\Sigma$  ( $7 \times 7$  in the example) has a  $3 \times 3$  nonzero block ( $\Sigma_3$ , assumed symmetric and positive definite), while all the other elements are zero.

$$\Sigma = \begin{matrix} (G \times G) \\ (7 \times 7) \end{matrix} \begin{bmatrix} \sigma_{1,1} & \sigma_{1,2} & \sigma_{1,3} & 0 & 0 & 0 & 0 \\ \sigma_{2,1} & \sigma_{2,2} & \sigma_{2,3} & 0 & 0 & 0 & 0 \\ \sigma_{3,1} & \sigma_{3,2} & \sigma_{3,3} & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 \end{bmatrix} = \begin{bmatrix} \Sigma_3 & 0 \\ 0 & 0 \end{bmatrix} \quad (3.5)$$

$\Pi$  is the  $(G \times K)$  matrix of reduced form coefficients ( $7 \times 8$  in the example).  $\Psi$  is the  $(G \times G)$  variance-covariance matrix of the reduced form error terms  $v_t$  ( $7 \times 7$  in the example).

$$\Pi = -B^{-1}\Gamma = \begin{matrix} (G \times K) \\ (7 \times 8) \end{matrix} \begin{bmatrix} \pi_{1,1} & \pi_{1,2} & \pi_{1,3} & \pi_{1,4} & \pi_{1,5} & \pi_{1,6} & \pi_{1,7} & \pi_{1,8} \\ \pi_{2,1} & \pi_{2,2} & \pi_{2,3} & \pi_{2,4} & \pi_{2,5} & \pi_{2,6} & \pi_{2,7} & \pi_{2,8} \\ \pi_{3,1} & \pi_{3,2} & \pi_{3,3} & \pi_{3,4} & \pi_{3,5} & \pi_{3,6} & \pi_{3,7} & \pi_{3,8} \\ \pi_{4,1} & \pi_{4,2} & \pi_{4,3} & \pi_{4,4} & \pi_{4,5} & \pi_{4,6} & \pi_{4,7} & \pi_{4,8} \\ \pi_{5,1} & \pi_{5,2} & \pi_{5,3} & \pi_{5,4} & \pi_{5,5} & \pi_{5,6} & \pi_{5,7} & \pi_{5,8} \\ \pi_{6,1} & \pi_{6,2} & \pi_{6,3} & \pi_{6,4} & \pi_{6,5} & \pi_{6,6} & \pi_{6,7} & \pi_{6,8} \\ \pi_{7,1} & \pi_{7,2} & \pi_{7,3} & \pi_{7,4} & \pi_{7,5} & \pi_{7,6} & \pi_{7,7} & \pi_{7,8} \end{bmatrix} \quad \Psi = B^{-1}\Sigma B'^{-1} \begin{matrix} (G \times G) \\ (7 \times 7) \end{matrix} \quad (3.6)$$

Matrices  $B$  and  $\Gamma$  are usually *sparse* matrices. Zeroes and ones represent *a-priori* restrictions on the structural form. In particular, considering only the behavioural stochastic equations (the first three equations in the example) zeroes represent *exclusion* restrictions, ones represent *normalization* restrictions. For instance, in the first equation the coefficient of  $C_t$  is 1, and not a generic  $\beta_{1,1}$  (normalization); the coefficient of  $I_t$ , is 0, and not a generic  $\beta_{1,2}$  (exclusion); the coefficient of  $T_t$ , is 0, and not a generic  $\gamma_{1,3}$  (exclusion); etc.

Matrices  $\Pi$  and  $\Psi$ , on the contrary, are usually *full* matrices; some of their elements are zeroes only exceptionally.

## 4 DYNAMIC SIMULTANEOUS EQUATIONS

There are problems for which it is necessary to distinguish between exogenous and lagged endogenous variables (for example, dynamic solution, *multi steps ahead* forecast, delay or cumulated multipliers). In these cases we still use the vectors  $y_t$ ,  $u_t$ ,  $v_t$  and the matrix  $B$  unchanged;  $z_t$  becomes a  $(5 \times 1)$  vector containing only the exogenous variables at time  $t$ ; the vector of lagged endogenous variables  $y_{t-1}$  is introduced explicitly (for homogeneity of representation, it has the same dimensions as  $y_t$ ,  $7 \times 1$  in the example); the matrix of structural form coefficients of the exogenous variables is indicated with  $D$ , and is a  $(7 \times 5)$  matrix (in practice it contains the first 5 columns of the matrix previously called  $\Gamma$  in equation 3.4); the matrix  $C$  ( $7 \times 7$ ) contains the structural form coefficients of the lagged endogenous variables (in practice it contains the last 3 columns of the matrix called  $\Gamma$  in equation 3.4, and 4 columns of zeroes, corresponding to the 4 endogenous variables that *do not appear* in the model with lag-1).

$$y_{t-1} = \begin{matrix} (7 \times 1) \end{matrix} \begin{bmatrix} C_{t-1} \\ I_{t-1} \\ W_{t-1}^p \\ X_{t-1} \\ P_{t-1} \\ K_{t-1} \\ W_{t-1} \end{bmatrix} \quad z_t = \begin{matrix} (5 \times 1) \end{matrix} \begin{bmatrix} 1 \\ W_t^g \\ T_t \\ A_t \\ G_t \end{bmatrix} \quad \begin{matrix} \begin{bmatrix} By_t + Dz_t + Cy_{t-1} = u_t \\ y_t = \Pi_0 y_{t-1} + \Pi_1 z_t + v_t \end{bmatrix} \end{matrix} \begin{matrix} \text{Structural form} \\ \text{Reduced form} \end{matrix} \quad (4.7)$$



$$D = \begin{matrix} (7 \times 5) \\ \begin{bmatrix} -\alpha_1 & 0 & 0 & 0 & 0 \\ -\alpha_5 & 0 & 0 & 0 & 0 \\ -\alpha_9 & 0 & 0 & -\alpha_{12} & 0 \\ 0 & 0 & 0 & 0 & -1 \\ 0 & 0 & 1 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & -1 & 0 & 0 & 0 \end{bmatrix} \end{matrix} \quad C = \begin{matrix} (7 \times 7) \\ \begin{bmatrix} 0 & 0 & 0 & 0 & -\alpha_3 & 0 & 0 \\ 0 & 0 & 0 & 0 & -\alpha_7 & -\alpha_8 & 0 \\ 0 & 0 & 0 & -\alpha_{11} & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & -1 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 \end{bmatrix} \end{matrix} \quad (4.8)$$

$$\Pi_0 = -B^{-1}C = \begin{matrix} (7 \times 7) \\ \begin{bmatrix} 0 & 0 & 0 & \pi_{01,4} & \pi_{01,5} & \pi_{01,6} & 0 \\ 0 & 0 & 0 & \pi_{02,4} & \pi_{02,5} & \pi_{02,6} & 0 \\ 0 & 0 & 0 & \pi_{03,4} & \pi_{03,5} & \pi_{03,6} & 0 \\ 0 & 0 & 0 & \pi_{04,4} & \pi_{04,5} & \pi_{04,6} & 0 \\ 0 & 0 & 0 & \pi_{05,4} & \pi_{05,5} & \pi_{05,6} & 0 \\ 0 & 0 & 0 & \pi_{06,4} & \pi_{06,5} & \pi_{06,6} & 0 \\ 0 & 0 & 0 & \pi_{07,4} & \pi_{07,5} & \pi_{07,6} & 0 \end{bmatrix} \end{matrix} \quad \Pi_1 = -B^{-1}D = \begin{matrix} (7 \times 5) \\ \begin{bmatrix} \pi_{11,1} & \pi_{11,2} & \pi_{11,3} & \pi_{11,4} & \pi_{11,5} \\ \pi_{12,1} & \pi_{12,2} & \pi_{12,3} & \pi_{12,4} & \pi_{12,5} \\ \pi_{13,1} & \pi_{13,2} & \pi_{13,3} & \pi_{13,4} & \pi_{13,5} \\ \pi_{14,1} & \pi_{14,2} & \pi_{14,3} & \pi_{14,4} & \pi_{14,5} \\ \pi_{15,1} & \pi_{15,2} & \pi_{15,3} & \pi_{15,4} & \pi_{15,5} \\ \pi_{16,1} & \pi_{16,2} & \pi_{16,3} & \pi_{16,4} & \pi_{16,5} \\ \pi_{17,1} & \pi_{17,2} & \pi_{17,3} & \pi_{17,4} & \pi_{17,5} \end{bmatrix} \end{matrix} \quad (4.9)$$

## 5 MULTIPLIERS, FORECASTS, GOODNESS OF FIT MEASURES

Recursive substitution into the reduced form system (4.7) gives

$$\begin{aligned} y_t &= \Pi_0 y_{t-1} + \Pi_1 z_t + v_t \\ &= \Pi_0^2 y_{t-2} + \Pi_0 \Pi_1 z_{t-1} + \Pi_1 z_t + \Pi_0 v_{t-1} + v_t \\ &= \Pi_0^3 y_{t-3} + \Pi_0^2 \Pi_1 z_{t-2} + \Pi_0 \Pi_1 z_{t-1} + \Pi_1 z_t + \Pi_0^2 v_{t-2} + \Pi_0 v_{t-1} + v_t \\ &= \text{etc.} \end{aligned} \quad (5.10)$$

The long run dynamic behaviour of the system depends on the powers of  $\Pi_0$ . In the example,  $\Pi_0$  is a  $(7 \times 7)$  nonsymmetric matrix, with 4 columns of zeroes; it has therefore 3 nontrivial eigenvalues (one of which is necessarily real, the other two can be real or conjugate complex) that ensure stability if all are less than one in modulus.

$$\begin{aligned} \Pi_1 &= \partial E[y_t | z_t, z_{t-1}, \dots] / \partial z_t && \text{matrix of impact multipliers;} \\ \Pi_0 \Pi_1 &= \partial E[y_t | z_t, z_{t-1}, \dots] / \partial z_{t-1} && \text{matrix of lag-1 delay multipliers;} \\ \Pi_0^2 \Pi_1 &= \partial E[y_t | z_t, z_{t-1}, \dots] / \partial z_{t-2} && \text{matrix of lag-2 delay multipliers;} \\ &&& \text{etc.} \end{aligned} \quad (5.11)$$

In the example, all these matrices have dimensions  $(7 \times 5)$ . Their sum, up to a given lag, is the matrix of *cumulated* or *sustained multipliers*.

Multipliers are fundamental tools for economic policy simulations.

The reduced form equations (3.2 or 4.7), coefficients ( $\Pi$ ,  $\Pi_0$  or  $\Pi_1$ ) and variance-covariance matrix ( $\Psi$ ) are called *restricted* if they derive (i.e. are computed) from the structural form (inverting matrix  $B$ , etc.). Otherwise they are called *unrestricted* (when we consider directly each reduced form equation as a the linear regression of an endogenous variable against all the exogenous and lagged endogenous variables).

All the expressions *restricted reduced form*, *reduced form derived from the structural form*, *simultaneous solution of the structural form equations* have exactly the same meaning. When talking of *static* or *one step ahead* solution of the structural form equations, reference is always done to (3.2). When talking of *dynamic* solution of the structural form equations, reference is always done to (4.7).

Forecasts, simulations and economic policy experiments are usually conducted using the restricted reduced form, deriving it from the structural form after a convenient estimate of the unknown coefficients has been computed ( $\alpha_1, \dots, \alpha_{12}$  in the example).

There is much more *economic theory* in the structural form than in the unrestricted reduced form.

Forecasts *one step ahead* are usually produced using the static notation (3.2), setting the random error terms  $v_t$  to zero (expected value). When data are available till time  $n$  (last sample observation) and forecast is performed for time  $n+1$ , some elements of the vector  $z_{n+1}$  are available from the sample (the lagged endogenous variables, since they are related to time  $n$ ). But the other elements of  $z_{n+1}$  (the exogenous variables) must be supplied from outside (usually, financial plans of the government, forecasts produced by central banks, etc.).

To produce forecasts *multi steps ahead* it is necessary to resort to the dynamic notation (4.7), still setting the random error terms  $v_t$  to zero at any time. For example, if data are available till time  $n$  (last sample observation) and forecast is performed for time  $n+1$  and  $n+2$ , we first forecast at  $n+1$  as above. Then, to forecast at  $n+2$ , the values of the lagged endogenous variables in  $z_{n+2}$  are taken from the forecast at  $n+1$ , while the exogenous variables at  $n+2$  must be supplied from outside. Etc.

In *sample* forecasts (historical tracking) and *goodness of fit* measures over the sample period can be both static or dynamic. In the static case, the structural form is always solved one step ahead, taking values of the lagged endogenous variables from the observed sample. In the dynamic case, the dynamic notation is used (4.7) and the values of the lagged endogenous

variables, in each period, are taken from the solution of the previous period. Initial values of the endogenous variables are always taken from the sample, so there is no difference between static and dynamic solution at the beginning of the sample period.

The following are the most common univariate measures of goodness of fit. Each formula is related to *one* endogenous variable;  $O_t$  is the *observed* value of the variable at time  $t$ ;  $C_t$  is the value of the variable at time  $t$  *computed* with the model (static or dynamic solution);  $o_t$  is the *observed growth rate* of the variable at time  $t$  (the annual percentage change, in the example);  $c_t$  is the growth rate of the variable at time  $t$  *computed* with the model (static or dynamic solution).

$$\begin{aligned}
RMSE &= \sqrt{\frac{\sum_{t=1}^n (O_t - C_t)^2}{n}} && \text{Root Mean Squared Error} \\
RMSE(dim) &= \sqrt{\frac{\sum_{t=1}^n (O_t - C_t)^2}{\sum_{t=1}^n O_t^2}} && \text{Dimensionless Root Mean Squared Error} \\
MAPE &= \frac{1}{n} \sum_{t=1}^n \frac{|O_t - C_t|}{O_t} \times 100 && \text{Mean Absolute Percentage Error} \\
Theil's U_1 &= \sqrt{\frac{\sum_{t=1}^n (o_t - c_t)^2}{\sum_{t=1}^n o_t^2}} && \text{Theil Inequality Coefficient (1966, eq.4.5)} \\
Theil's U_2 &= \sqrt{\frac{\sum_{t=1}^n (o_t - c_t)^2}{\sum_{t=1}^n (o_t - \bar{o})^2}} && \text{Theil Inequality Coefficient (1966, eq.4.6)}
\end{aligned} \tag{5.12}$$

$MAPE$  and Theil's inequality coefficients are not computed for variables that change sign over the sample period (such as  $I_t$  in the example).

## 6 IDENTIFICATION BY MEANS OF A-PRIORI RESTRICTIONS

We consider in detail the case of *a-priori* restrictions on coefficients, in particular *exclusion* restrictions. Covariance restrictions are briefly discussed at the end.

**Definition.** Two *different* structural form systems

$$\begin{cases} By_t + \Gamma z_t = u_t \\ Var(u_t) = \Sigma \end{cases} \quad \text{and} \quad \begin{cases} B^* y_t + \Gamma^* z_t = u_t^* \\ Var(u_t^*) = \Sigma^* \end{cases} \tag{6.13}$$

are called *observationally equivalent* if they have the *same reduced form*.

More precisely, let the corresponding reduced form systems be

$$\begin{cases} y_t = \Pi z_t + v_t \\ v_t = B^{-1} u_t \\ \Pi = -B^{-1} \Gamma; \\ \Psi = Var(v_t) = B^{-1} \Sigma B'^{-1} \end{cases} \quad \text{and} \quad \begin{cases} y_t = \Pi^* z_t + v_t^* \\ v_t^* = B^{*-1} u_t^* \\ \Pi^* = -B^{*-1} \Gamma^*; \\ \Psi^* = Var(v_t^*) = B^{*-1} \Sigma^* B^{*-1} \end{cases} \tag{6.14}$$

then, the two structural form systems (6.13) are called *observationally equivalent till the second moments* if  $\Pi^* = \Pi$  and  $\Psi^* = \Psi$ . If this happens, it will be impossible to discriminate between the two different structural forms on the basis of the observed data, since data (the values of  $y_t$ ) are produced by the reduced form.

**Definition.** A parameter (or an equation) of the structural form is *identified* if it (or the equation's parameters) can be deduced from knowledge of the reduced form parameters  $\Pi$  and  $\Psi$ .

**Theorem.** Two structural forms (6.13) are observationally equivalent if and only if there exists a non-singular square matrix  $F$  (same dimensions as  $B$ ) such that  $B^* = FB$ ,  $\Gamma^* = F\Gamma$ , and  $\Sigma^* = F\Sigma F'$ .

The proof is straightforward. In fact, if  $B^* = FB$ ,  $\Gamma^* = F\Gamma$ , and  $\Sigma^* = F\Sigma F'$ , then  $\Pi^* = -B^{*-1} \Gamma^* = -(FB)^{-1} (F\Gamma) = -B^{-1} F^{-1} F\Gamma = -B^{-1} \Gamma = \Pi$ ; moreover  $\Psi^* = B^{*-1} \Sigma^* B^{*-1} = (FB)^{-1} F\Sigma F' (FB)^{-1} = B^{-1} F^{-1} F\Sigma F' F'^{-1} B'^{-1} = B^{-1} \Sigma B'^{-1} = \Psi$ .

Viceversa, if  $\Pi^* = \Pi$ , then  $B^{*-1} \Gamma^* = B^{-1} \Gamma$  and pre-multiplication of both sides by  $B^*$  gives  $\Gamma^* = B^* B^{-1} \Gamma$ ; thus,  $B^* = FB$  and  $\Gamma^* = F\Gamma$ , having defined  $F = B^* B^{-1}$ . Also,  $\Psi^* = \Psi$  implies that  $B^{*-1} \Sigma^* B^{*-1} = B^{-1} \Sigma B'^{-1}$ , where pre-multiplication of both sides by  $B^*$  and post-multiplication by  $B^{*'} gives  $\Sigma^* = B^* B^{-1} \Sigma B'^{-1} B^{*'} = F\Sigma F'$ , having defined  $F$  as above.$

The theorem implies that, given a structural form  $By_t + \Gamma z_t = u_t$ , there will be an infinity of other structural forms, different from it, but observationally equivalent to it: any non-singular square matrix  $F$ , arbitrarily chosen, will in fact produce the matrices  $B^*$ ,  $\Gamma^*$  and  $\Sigma^*$  of an observationally equivalent structural form. Notice that each row of  $B^*$  and  $\Gamma^*$  would be a linear combination of the rows of  $B$  and  $\Gamma$ .

## 6.1 Restrictions and admissible transformations

It may happen that pre-multiplication by  $F$  produces matrices  $B^*$  and  $\Gamma^*$  that do not satisfy the *a-priori* restrictions of  $B$ ,  $\Gamma$  and  $\Sigma$ . For instance, it may happen that  $\beta_{1,2}^*$  is nonzero, while  $\beta_{1,2} = 0$  in the original model; this means that the variable  $I_t$  was *excluded*, by the economic theory of the model's builder, from the first equation of  $By_t + \Gamma z_t = u_t$ , but is *included* in the first equation of  $B^*y_t + \Gamma^*z_t = u_t^*$ . Exclusion restrictions are a particular case of *homogeneous* restrictions. They are the only type of homogeneous restrictions in the model used as example.

**Definition.** A linear transformation produced by a non-singular matrix  $F$  is *admissible* if the transformed structural form coefficients  $[B^*; \Gamma^*]$  satisfy all the *a-priori* restrictions on  $[B; \Gamma]$  and the transformed variance-covariance matrix  $\Sigma^*$  satisfies all the *a-priori* restrictions on  $\Sigma$ .

To simplify the problem, we only consider restrictions on coefficients, without considering possible restrictions on the variance-covariance matrix (which are rather unusual); for further simplification, we first consider only homogeneous restrictions (and later normalization restrictions). To fix ideas, we focus on the first equation of the structural form model (consumption, in the example).

The  $(G \times G)$  *unit* (or *identity*) matrix obviously produces an admissible transformation. Any  $(G \times G)$  *scalar* matrix (the identity matrix multiplied by a nonzero scalar) also produces an admissible transformation (exclusion restrictions are preserved, as well as homogeneous restrictions in general).

If an admissible matrix  $F$  exists, and it is different from a scalar matrix, this implies that an alternative structural form  $B^*y_t + \Gamma^*z_t = u_t^*$  exists, which is observationally equivalent to the original model  $By_t + \Gamma z_t = u_t$ , satisfies all the *a-priori* restrictions on the original model, but has one or more coefficients different from the original model: thus, some coefficients (or equations) are not identified. If this happens for some coefficients of the first equation, then the first equation is not identified. If this *cannot* happen in the first equation (even if it may happen in other equations), then the first equation is identified.

Notice that, when pre-multiplying by  $F$  the matrices  $B$  and  $\Gamma$  to produce  $B^*$  and  $\Gamma^*$ , the first row (structural coefficients of the consumption equation, in the example) is

$$[B^*; \Gamma^*]_{1,\bullet} = [F(B; \Gamma)]_{1,\bullet} = F_{1,\bullet}[B; \Gamma] \quad (6.15)$$

If such a  $F_{1,\bullet}$  produces a first row of structural coefficients satisfying all the restrictions on the first equation of the original model, the first equation is not identified. If only the first row of the unit matrix or the first row of a scalar matrix can do it, and no other  $F_{1,\bullet}$ , then the first equation is identified.

A representation of the exclusion restrictions in the first equation can be obtained introducing the matrix  $\Phi_1$ . In the example such a matrix is

$$\Phi_1 = \begin{bmatrix} 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 1 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 1 \end{bmatrix} \quad (6.16)$$

The number of columns,  $R_1$ , is the number of exclusion restrictions from the first structural form equation of the model. The whole system includes  $G + K = 15$  variables, and the first structural form equation includes 5 variables (a dependent variable, and 4 variables on the right hand side); therefore the number of exclusions is  $R_1 = 15 - 5 = 10$ . Each column corresponds to an excluded variable, and contains a unique nonzero element ( $= 1$ ), indicating which variable is excluded.

For example, considering the list of all the variables of the model (beginning with the endogenous variables, followed by the exogenous and lagged endogenous variables) the first variable of the list is  $C_t$ , which is included in the first equation, and therefore corresponds to no column. The following variable in the list is  $I_t$  and it is excluded from the equation. Since it is the first variable excluded from the equation, and it is the second variable in the list of all variables, then in the first column there is a value  $= 1$  in the second row. The following variable in the list is  $W_t^p$ , and it is also excluded from the equation. Since it is the second variable excluded from the equation, and it is the third in the list of all variables, then in the second column there is a value  $= 1$  in the third row. And so on.

Matrix  $\Phi_1$  is such that the coefficients of the first structural form equation satisfy the system of  $R_1$  ( $= 10$  in the example) linear homogeneous equations

$$[B; \Gamma]_{1,\bullet} \Phi_1 = 0 \quad (6.17)$$

## 6.2 Rank condition - Order condition

An admissible transformation matrix  $F$  has its first row ( $F_{1,\bullet}$ ) that must produce transformed coefficients satisfying the analogous system of equations

$$[B^*; \Gamma^*]_{1,\bullet} \Phi_1 = 0 \quad (6.18)$$

that is, substituting (6.15)

$$F_{1,\bullet} [B ; \Gamma] \Phi_1 = 0 \quad (6.19)$$

This can be viewed as a system of  $R_1$  ( $= 10$ ) homogeneous equations with  $G$  ( $= 7$ ) unknowns (the elements of  $F_{1,\bullet}$ ). The matrix of coefficients is  $[B ; \Gamma]\Phi_1$ , and its dimensions are  $(G \times R_1)$  ( $7 \times 10$  in the example). If the rank of this matrix of coefficients is  $G$  ( $= 7$ ), then the system (6.19) has the unique solution  $F_{1,\bullet} = 0$ . This is obviously impossible, because also  $F_{1,\bullet} = I_{1,\bullet}$  (the first row of the unit matrix) is for sure a solution of the system.

If the rank of this matrix of coefficients is  $G - 1$  ( $= 6$  in the example), then the system (6.19) would have  $\infty^1$  solutions for  $F_{1,\bullet}$ , and all these solutions would be proportional to  $I_{1,\bullet}$ , the first row of the unit matrix (in other words, the first row of an arbitrary scalar matrix would be a solution, and there would be no other solutions). These  $\infty^1$  solutions are reduced to a single solution after imposing the *normalization* restriction  $\beta_{1,1} = 1$  (the coefficient of  $C_t$  in the first equation of the example is not a generic  $\beta_{1,1}$ , but is fixed to 1). Thus, the first equation is identified.

If the rank of this matrix of coefficients is  $G - 2$  or less (5 or less than 5 in the example), then the system (6.19) would have  $\infty^2$  or more solutions for  $F_{1,\bullet}$ , and not all would be proportional to  $I_{1,\bullet}$ , the first row of the unit matrix. These solutions would not be reduced to a single solution after imposing the *normalization* restriction  $\beta_{1,1} = 1$ . Thus, there would be other observationally equivalent structural forms whose first equation satisfies all the *a-priori* restrictions on the original first equation, but coefficients would be different. Thus the first equation would not be identified.

The above discussion can be summarized in the following condition, which is necessary and sufficient.

**Theorem** (*rank condition*). The  $i$ -th structural form equation is identified if and only if  $\text{rank}[(B ; \Gamma)\Phi_i] = G - 1$ .

Considering that  $B$  is non-singular, so that necessarily  $\text{rank}[B ; \Gamma] = G$  ( $= 7$  in the example), and that the rank of a product of matrices is smaller than or equal to the smallest of the ranks, it is necessary that  $\text{rank}[\Phi_1] \geq G - 1$ , otherwise the rank condition cannot hold. This is a *necessary but not sufficient* condition, known as the *order condition*.

For the case of exclusion restrictions, the order condition can be stated in very simple terms. We first consider that the rank of  $\Phi_1$  equals the number of columns of  $\Phi_1$ , or number of exclusion restrictions  $R_1$  ( $= 10$  in the example). Thus the order condition becomes  $R_1 \geq G - 1$ . We then consider that the whole structural form system includes  $G + K$  variables, but  $R_1$  of these variables are excluded from the first equation, so the number of included variables in the first equation is  $G - R_1 + K$ . Considering now that one of these variables is on the left hand side of the structural equation (the dependent variable,  $C_t$  in the example), there are  $G - 1 - R_1 + K$  variables on the right hand side of the first equation (the regressors, or explanatory variables in the structural equation of consumption). When  $R_1 \geq G - 1$  (as stated above), then the number of regressors on the right hand side of the structural equation  $G - 1 - R_1 + K$  will be  $\leq K$ . Summarizing

**Theorem** (*order condition*). A necessary (but not sufficient) condition for a structural form equation to be identified is that the number of regressors on the right hand side of the equation must not exceed  $K$ , the total number of exogenous and lagged endogenous variables of the system.

Stated as above, the order condition is quite intuitive. We cannot have in a single structural equation more regressors than *independent inputs* in the whole system, which are the exogenous and lagged endogenous variables of the system.

The same condition (order) is presented by some textbooks in the following (equivalent) way: the number of exogenous (and lagged endogenous) variables excluded from a structural equation must be at least as large as the number of endogenous variables included, less one.

**Definitions.** The first structural form equation is called *just-identified* (or *exactly identified*) if it is identified (i.e. the rank condition is satisfied), and  $\text{rank}[\Phi_1] = G - 1$ .

The first structural form equation is called *over-identified* if it is identified (i.e. the rank condition is satisfied), and  $\text{rank}[\Phi_1] > G - 1$ .

If  $\text{rank}[\Phi_1] < G - 1$ , then the rank condition cannot be satisfied and the equation is not identified; it can also be called *under-identified*.

## 6.3 Remarks

Matrix  $\Phi_1$  would be more complex if restrictions other than exclusion were introduced. For instance, the first structural equation of the Klein-I model (the private consumption equation) is more usually presented as

$$C_t = \alpha_1 + \alpha_2 P_t + \alpha_3 P_{t-1} + \alpha_4 (W_t^p + W_t^g) + u_{1,t}$$

This would avoid the need of the seventh equation, and the endogenous variables would be 6 rather than 7. But at the same time it would make more complex the structure of the matrices. In fact, the *same* coefficient  $\alpha_4$  would multiply the sum of two variables. This would be an additional restriction, and should be properly considered either in the matrices  $B$  and  $\Gamma$  ( $\alpha_4$  should appear in both matrices) or in matrix  $\Phi_1$  (where a column should contain a +1 and a -1 in the proper rows).

Other types of restrictions can be found in econometric models. For example, the *constant return to scale* hypothesis in a Cobb-Douglas production function implies that two (or more) structural coefficients sum to one. This is a *nonhomogeneous* restriction on coefficients and would require some changes in the rank condition (6.19 would be replaced by a nonhomogenous equation system and the normalization restriction should be directly introduced into the system, rather than at the end as above).

#### 6.4 Demand - supply model

If we consider the following model in structural form

$$\begin{cases} Q_i^d = \alpha_1 + \alpha_2 P_i + u_{1,i} & \text{Demand} \\ Q_i^s = \alpha_3 + \alpha_4 P_i + u_{2,i} & \text{Supply} \\ Q_i^d = Q_i^s & \text{Equilibrium} \end{cases} \quad (6.20)$$

neither demand nor supply equations are identified, since they both fail the order condition (necessary). The model, in fact, has 3 endogenous variables ( $Q_i^d$  = demand,  $Q_i^s$  = supply,  $P_i$  = equilibrium price) and only one exogenous variable (the constant); so  $K = 1$ , while each of the first two equations would have two explanatory variables (regressors).

Intuitively the lack of identification has a quite simple explanation. We expect that demand is a decreasing function of price, thus  $\alpha_2 < 0$ , while supply is expected to be an increasing function of price, thus  $\alpha_4 > 0$ . In the two-dimensional plane ( $Q$ ,  $P$ ) the two straight lines would cross in a unique point (the equilibrium value of  $Q$  and  $P$ ). This point would remain fix for any  $i$  (the simultaneous solution of the equation system). If the model is correctly specified, observations at various times would be points scattered around this unique solution point (maybe very close to it, if the random error terms  $u_{1,i}$  and  $u_{2,i}$  are small). Such a scatter diagram makes it impossible to distinguish between a demand (decreasing) function and a supply (increasing) function of price.

We could introduce an additional explanatory variable (exogenous) into the supply equation, for instance  $L_i$  = cost of labour and/or raw materials:  $Q_i^s = \alpha_3 + \alpha_4 P_i + \alpha_5 L_i + u_{2,i}$ . The order condition would now be satisfied by the *first* structural equation (demand); there would be in fact  $K = 2$  exogenous variables in the system, the constant and  $L_i$ , and there would be two regressors in the equation. Some simple algebra could show that also the rank condition is satisfied by the first equation if  $\alpha_5 \neq 0$ . The second equation (supply) would be still under-identified.

There is again an intuitive explanation of all this. We could still represent the demand and supply functions in the two dimensional plane. Values of the additional exogenous variable  $L_i$ , changing with  $i$ , would *shift* the supply line in the plane. There would be, therefore, several intersection points between demand and supply (equilibrium values of  $Q$  and  $P$  for different values of  $L_i$ ). All these points would be *on the demand* line (that does not shift). If the model is correctly specified, observations at various  $i$ -s would be points scattered around the solution points, therefore they would be scattered along the demand line, making it *visible*. There would be, however, no chance to identify the supply function.

#### 6.5 Some remarks on variance-covariance restrictions

Restrictions on variances and covariances help identification (but they are quite unusual). For example, if the first equation is not identified by means of exclusion restrictions, it could be identified by imposing restrictions on the first row (and first column) of the  $\Sigma$  matrix. In particular, the variance could be known, or some covariances could be zero.

We still consider linear restrictions, but not necessarily homogeneous, so that the right hand side of equations (6.17) and (6.19) will be a constant vector  $r_1$ , not necessarily equal to zero. If we impose  $S_1$  restrictions on the first row of  $\Sigma$  ( $\Theta_1$  is the matrix of restrictions)

$$\Sigma_{1,\bullet} \Theta_1 = s_1 \quad (6.21)$$

an admissible transformation matrix  $F$  must have the first row satisfying the system of  $R_1 + S_1$  equations

$$\begin{cases} F_{1,\bullet} [B ; \Gamma] \Phi_1 = r_1 \\ F_{1,\bullet} \Sigma F' \Theta_1 = s_1 \end{cases} \quad (6.22)$$

The system is *nonlinear* in the unknown  $F_{1,\bullet}$ . We can nevertheless discuss the problem considering what could be its solution if  $F$  was treated as *fixed*, and the unknown  $F_{1,\bullet}$  was considered as *not belonging* to  $F$ . In such a way we derive a condition which is necessary, but not sufficient.

The first equation of the model is identified if, and only if, for any admissible  $F$ , the unique solution of the system (6.22) is  $F_{1,\bullet} = I_{1,\bullet}$  (unit row vector). The matrix  $F = I$  is surely admissible, so we fix  $F = I$ ; then, the solution  $F_{1,\bullet} = I_{1,\bullet}$  must be unique, and this holds when  $\text{rank}[(B ; \Gamma) \Phi_1 ; \Sigma \Theta_1] = G$ . This is called *generalized rank condition*. It is a necessary condition. It ensures that there cannot be a solution different from  $F_{1,\bullet} = I_{1,\bullet}$ , but having treated  $F_{1,\bullet}$  and  $F$  separately, the condition does not ensure the existence of a solution; thus, the condition is not sufficient.

To ensure a  $\text{rank} = G$ , the matrix, which has  $G$  rows, must have at least  $G$  columns. The number of columns is  $R_1 + S_1$ . Therefore it must be  $R_1 + S_1 \geq G$ , which is the *generalized order condition* (also necessary, but not sufficient). When  $R_1$  is too small, and thus identification is not ensured by means of restrictions on coefficients,  $R_1 + S_1$  could be large enough, and the first equation of the model might be identified.

## 7 ASYMPTOTIC PROPERTIES OF ORDINARY LEAST SQUARES (OLS)

Let's consider the linear regression model

$$y = X\beta + u \quad (7.23)$$

where

$$\begin{aligned} y = \begin{bmatrix} y_1 \\ y_2 \\ \dots \\ y_t \\ \dots \\ y_n \end{bmatrix} \quad (n \times 1) \quad X = \begin{bmatrix} x_{1,1} & x_{1,2} & \dots & x_{1,k} \\ x_{2,1} & x_{2,2} & \dots & x_{2,k} \\ \dots & \dots & \dots & \dots \\ x_{t,1} & x_{t,2} & \dots & x_{t,k} \\ \dots & \dots & \dots & \dots \\ x_{n,1} & x_{n,2} & \dots & x_{n,k} \end{bmatrix} \quad (n \times k) \quad \beta = \begin{bmatrix} \beta_1 \\ \beta_2 \\ \dots \\ \beta_k \end{bmatrix} \quad (k \times 1) \quad u = \begin{bmatrix} u_1 \\ u_2 \\ \dots \\ u_t \\ \dots \\ u_n \end{bmatrix} \quad (n \times 1) \end{aligned}$$

$$\begin{cases} u_t : i.i.d. \\ E[u] = 0 \\ V[u] = E[uu'] = \sigma^2 I_n \end{cases} \quad (7.24)$$

OLS estimator of coefficients is

$$\hat{\beta} = (X'X)^{-1}X'y \quad (7.25)$$

Substituting  $y = X\beta + u$  into the above expression, we get the *estimation error*

$$\hat{\beta} - \beta = (X'X)^{-1}X'u = \left(\frac{X'X}{n}\right)^{-1} \frac{X'u}{n} \quad (7.26)$$

and the *estimation error rescaled by  $\sqrt{n}$*

$$\sqrt{n}(\hat{\beta} - \beta) = \left(\frac{X'X}{n}\right)^{-1} \frac{X'u}{\sqrt{n}} \quad (7.27)$$

We assume that the  $k \times k$  matrix  $X'X/n$  is non-singular for any  $n$  (classical hypothesis), and converges to a non-singular and finite limit as  $n \rightarrow \infty$ . If no random variables are contained in the matrix  $X$ , then *convergence* for  $X'X/n$  is in *mathematical* sense (*lim*), otherwise we are dealing with convergence in *probability* (*plim*) to a constant matrix. *Trends* are therefore excluded (otherwise the limit would not be finite).

We *roughly* consider four different cases.

### 7.1 First case

The matrix of explanatory variables,  $X$ , does not contain random variables. In this case, from (7.26) we get

$$E[\hat{\beta} - \beta] = (X'X)^{-1}E[X'u] = (X'X)^{-1}X'E(u) = 0$$

and

$$plim[\hat{\beta} - \beta] = \lim \left(\frac{X'X}{n}\right)^{-1} plim \frac{X'u}{n} = \lim \left(\frac{X'X}{n}\right)^{-1} plim \frac{1}{n} \sum_{t=1}^n x_t u_t = 0$$

The last equality follows directly from the weak law of large numbers (WLLN) observing that the *plim* is the probability limit of the average of  $n$  vectors ( $k \times 1$ ), each of which has zero expected value:  $E(x_t u_t) = x_t E(u_t) = 0$ .

So in this case the OLS estimator is *unbiased* and *consistent*.

### 7.2 Second case

The matrix of explanatory variables,  $X$ , contains some random variables, but these random variables are *independent* from the error terms  $u$  (*strictly exogenous*).

Also in this case the OLS estimator is *unbiased* and *consistent*. The only difference, with respect to the previous case, is that the limit of  $(X'X/n)$  must be a probability limit, rather than a limit in mathematical sense.

### 7.3 Third case

*Contemporaneous* explanatory variables and error terms are independent, but some explanatory variables at time  $t$  (elements of the vector  $x_t$ ) may be not independent of  $u_s$  for some  $s \neq t$ . This is, for example, the case of a model where the *lagged* dependent variable  $y_{t-1}$  is one of the explanatory variables, or, more generally, when  $x_t$  contains some *lagged endogenous* variables.

In this case the OLS estimator is *biased*, but *consistent*.

Bias follows from  $E[\hat{\beta} - \beta] = E[(X'X)^{-1}X'u] \neq (X'X)^{-1}X'E(u)$ , because the *whole* vector  $u$  is not independent of the *whole* matrix  $X$ , and so the result is generally  $\neq 0$ .

Consistency follows still from (7.26) observing that

$$plim \frac{X'u}{n} = plim \frac{1}{n} \sum_{t=1}^n x_t u_t = lim \frac{1}{n} \sum_{t=1}^n E[x_t u_t] \quad (7.28)$$

which is  $= 0$ , because each of the  $n$  vectors ( $k \times 1$ ) in the sum has zero expected value:  $E(x_t u_t) = E(x_t)E(u_t) = 0$ , being the *contemporaneous*  $x_t$  and  $u_t$  independent.

Of course, the vectors in the sum are not independent of each other; for instance,  $x_t$  may contain a lagged endogenous variable, that is a function of  $u_{t-1}$ , so that  $x_t u_t$  and  $x_{t-1} u_{t-1}$  are not independent vectors. So it is necessary to resort to a *suitable* form of the weak law of large numbers (WLLN) for *non-independent* sequences.

#### 7.4 Fourth case

*Contemporaneous* explanatory variables and error terms are not independent. In other words, some of the explanatory variables at time  $t$  (elements of the vector  $x_t$ ) are not independent of  $u_t$ . This is, for example, the case of a model where a *current endogenous* variable is one of the explanatory variables of the equation (for example, a structural form equation of a simultaneous equation model).

In this case the OLS estimator is *biased* (as in the previous case) and *inconsistent*.

Inconsistency follows observing that (7.28) usually produces a result  $\neq 0$ , because the *contemporaneous*  $x_t$  and  $u_t$  are not independent, so that each of the  $n$  vectors ( $k \times 1$ ) has *nonzero* expected value:  $E[x_t u_t] \neq 0$ ,

Therefore, in this last case it is necessary to resort to estimation methods different from OLS.

### 8 INSTRUMENTAL VARIABLES (I.V.)

Let  $W$  be a  $n \times k$  matrix (same dimensions as  $X$ ), such that the two  $k \times k$  matrices  $W'X/n$  and  $W'W/n$  are both non-singular for any  $n$ , and both converge to finite, non-singular, *constant* limits as  $n \rightarrow \infty$ .

*Temporarily* we assume that the matrix  $W$  *does not contain random variables*. This assumption will help in simplifying the first proofs of the next section; then it will be relaxed, and random variables (with some limitations) will be admitted into  $W$ . Thus, *convergence* for  $W'W/n$  is in *mathematical* sense (*lim*), while for  $W'X/n$  is in *probability* (*plim*), if  $X$  contains random variables.

Define the *instrumental variable estimator* (that makes use of  $W$  as a matrix of instruments) as

$$\tilde{\beta}_W = (W'X)^{-1}W'y \quad (8.29)$$

Substituting into the above expression  $y = X\beta + u$  we get the estimation error

$$\tilde{\beta}_W - \beta = (W'X)^{-1}W'u = \left(\frac{W'X}{n}\right)^{-1} \frac{W'u}{n} \quad (8.30)$$

and the estimation error rescaled by  $\sqrt{n}$

$$\sqrt{n}(\tilde{\beta}_W - \beta) = \left(\frac{W'X}{n}\right)^{-1} \frac{W'u}{\sqrt{n}} \quad (8.31)$$

### 9 ASYMPTOTIC PROPERTIES OF INSTRUMENTAL VARIABLE ESTIMATOR

We have the following preliminary results.

$$plim \frac{W'u}{n} = 0 \quad (9.32)$$

This follows from the weak law of large numbers (WLLN) observing that  $W'u/n = \sum_{t=1}^n w_t u_t / n$  is the  $(k \times 1)$  vector *arithmetical average* of the  $n$  vectors  $w_t u_t$ , each of which has zero expected value:  $E(w_t u_t) = w_t E(u_t) = 0$ .

$$\frac{W'u}{\sqrt{n}} \xrightarrow[n \rightarrow \infty]{distr} N\left(0, \sigma^2 lim \frac{W'W}{n}\right) \quad (9.33)$$

This can be easily proved considering that the  $(k \times 1)$  vector  $W'u/\sqrt{n}$  has zero expected value and variance-covariance matrix  $E(W'u u' W)/n = W'E(u u')W/n = W'\sigma^2 I_n W/n = \sigma^2 W'W/n$ . This expression of the variance-covariance matrix is valid for any  $n$ , therefore also in the limit. The normal distribution is obtained by a straightforward application of the central limit theorem.

## 9.1 Consistency and asymptotic normality of the Instrumental Variable estimator

If we consider the estimation error (8.30), then

$$plim(\tilde{\beta}_W - \beta) = plim \left[ \left( \frac{W'X}{n} \right)^{-1} \frac{W'u}{n} \right] = plim \left( \frac{W'X}{n} \right)^{-1} plim \frac{W'u}{n} = 0 \quad (9.34)$$

as it follows from (9.32). If we consider the estimation error rescaled by  $\sqrt{n}$  (8.31), then

$$\sqrt{n}(\tilde{\beta}_W - \beta) = \left( \frac{W'X}{n} \right)^{-1} \frac{W'u}{\sqrt{n}} \xrightarrow[n \rightarrow \infty]{distr} N \left[ 0, \sigma^2 \left( plim \frac{W'X}{n} \right)^{-1} lim \frac{W'W}{n} \left( plim \frac{X'W}{n} \right)^{-1} \right] \quad (9.35)$$

This follows from considering separately the limits of the two elements of the product:  $(W'X/n)^{-1}$ , whose limit is the inverse of the *constant*  $plim W'X/n$ , and  $W'u/\sqrt{n}$  whose limit is the multivariate normal distribution, with zero mean, given in (9.33).

## 9.2 Efficient instrumental variables: expectations of regressors

Since  $w_t$  does not contain random variables, it is

$$E(w_t x'_t) = w_t E(x'_t) \quad (9.36)$$

Then

$$plim \frac{W'X}{n} = lim \frac{W'E(X)}{n} \quad (9.37)$$

which follows from a straightforward application of some *suitable version* of the weak law of large numbers (WLLN), observing that  $W'X/n = \sum_{t=1}^n w_t x'_t/n$  is the  $(k \times k)$  matrix *arithmetical average* of the  $n$  matrices  $w_t x'_t$ , each of which has expected value given by (9.36). Finally,  $W'E(X)/n = \sum_{t=1}^n w_t E(x'_t)/n$  is the  $(k \times k)$  matrix *arithmetical average* of the  $n$  matrices containing the expected values  $w_t E(x'_t)$ . By assumption, the limit exists and is a finite non-singular matrix. Moreover, it is clear from the right hand side of (9.37) that it does not contain random variables (so it can be treated as a *constant*).

Applying (9.37), the asymptotic variance-covariance matrix in (9.35) can be written as

$$\sigma^2 \left( plim \frac{W'X}{n} \right)^{-1} lim \frac{W'W}{n} \left( plim \frac{X'W}{n} \right)^{-1} = \sigma^2 \left( lim \frac{W'E(X)}{n} \right)^{-1} lim \frac{W'W}{n} \left( lim \frac{E(X')W}{n} \right)^{-1} \quad (9.38)$$

If we choose  $W = E(X)$ , the above asymptotic variance-covariance matrix becomes

$$\sigma^2 \left( lim \frac{E(X')E(X)}{n} \right)^{-1} \quad (9.39)$$

For any other choice of  $W$ , the asymptotic variance-covariance matrix (9.38) cannot be smaller than (9.39)

$$\sigma^2 \left( lim \frac{W'E(X)}{n} \right)^{-1} lim \frac{W'W}{n} \left( lim \frac{E(X')W}{n} \right)^{-1} \geq \sigma^2 \left( lim \frac{E(X')E(X)}{n} \right)^{-1} \quad (9.40)$$

according to Schwarz inequality.

Thus  $W = E(X)$  can be called the matrix of *efficient instrumental variables*.

## 9.3 Efficient instrumental variables: conditional expectations of regressors

Sections 9, 9.1 and 9.2 proved consistency, asymptotic normality and efficiency, confining to “non-random variables only” the choice of the instrumental variables (elements of the matrix  $W$ ). Quite similar results hold, still under the assumptions (7.24), if we “enlarge” the choice of the instrumental variables. We admit also random variables among the elements of  $W$ , provided that, at time  $t$ , all the elements of  $w_t$  are *independent* from the random error terms  $u_t, u_{t+1}, u_{t+2}, \dots$ . Notice that the “independence” requirement is stronger than strictly necessary, and is here assumed to simplify the proofs. It is, however, important to notice that it would *not be enough* to assume that  $u_t$  and  $w_t$  are not correlated. The same consideration holds for the *strong* assumption on the  $u_t$  (i.i.d., eq. 7.24, rather than simply not autocorrelated).

Exogenous variables can be random variables, but they satisfy the requirement, and so they can be used as elements of  $W$ . At time  $t$ , *lagged* endogenous variables (lagged one or more periods) also satisfy the requirement, so they can be used as elements of  $w_t$ . On the contrary, the value of *current* endogenous variables (or future endogenous variables) cannot be used as elements of  $w_t$ .

Since all the variables in the simplified world summarized by the model are included in the vectors  $y_t$  and  $z_t$ , for varying  $t$ , the vector of instrumental variables at time  $t$ ,  $w_t$ , can include any element of  $z_t, z_{t-1}, z_{t-2}, \dots$ , but no element of  $y_t, y_{t+1}, \dots$ . In principle, it might also contain any exogenous element of  $z_{t+1}, z_{t+2}, \dots$ , but no lagged endogenous element of  $z_{t+1}, z_{t+2}, \dots$ . The set of variables that can be used as elements of  $w_t$  will be indicated as  $\mathfrak{I}_t$ . It contains, as a subset, all the *nonrandom* variables that were considered as the only possible elements of  $W$  in the previous sections.



With some simple changes, the main results of sections 9, 9.1 and 9.2 can now be proved under the new, less restrictive conditions on the instrumental variables choice. The differences will be  $E(x_t|\mathfrak{S}_t)$  replacing  $E(x_t)$  in all the formulas, and *plim* replacing *lim* when the sequences contain random variables.

Analogously to (9.32) we have

$$plim \frac{W'u}{n} = 0 \quad (9.41)$$

because  $W'u/n = \sum_{t=1}^n w_t u_t / n$  is the  $(k \times 1)$  vector *arithmetical average* of the  $n$  vectors  $w_t u_t$ , each of which has zero expected value:  $E(w_t u_t) = E(w_t)E(u_t) = 0$ .

Analogously to (9.33) we have

$$\frac{W'u}{\sqrt{n}} \xrightarrow[n \rightarrow \infty]{distr} N \left( 0, \sigma^2 plim \frac{W'W}{n} \right) \quad (9.42)$$

This follows from some *suitable version* of the central limit theorem (CLT, for non-independent sequences), considering that the  $(k \times 1)$  vector  $W'u/\sqrt{n} = \sum_{t=1}^n w_t u_t / \sqrt{n}$ , where each term has zero expected value. Computing its variance-covariance matrix, we get  $E(W'u u' W)/n = E[(\sum_{t=1}^n w_t u_t)(\sum_{t=1}^n w'_t u'_t)]/n = E[\sum_{t=1}^n w_t w'_t u_t^2]/n + E[\sum_{r \neq s} w_r w'_s u_r u_s]/n$  (notice that each element in the second sum is zero being always *one of the*  $u_r$  or  $u_s$  independent of all the other terms of the product)  $= \sum_{t=1}^n E[u_t^2 w_t w'_t]/n$  (notice also that the independence of  $u_t$  from  $w_t$  implies independence of  $u_t^2$  as well; it would not happen if they were simply not correlated)  $= \sum_{t=1}^n [E(u_t^2)E(w_t w'_t)]/n = \sigma^2 \sum_{t=1}^n E[w_t w'_t]/n$ , whose limit is  $\sigma^2 plim W'W/n$  (having applied some *suitable* WLLN for non-independent sequences).

Analogously to (9.35) we have

$$\sqrt{n}(\tilde{\beta}_W - \beta) = \left( \frac{W'X}{n} \right)^{-1} \frac{W'u}{\sqrt{n}} \xrightarrow[n \rightarrow \infty]{distr} N \left[ 0, \sigma^2 \left( plim \frac{W'X}{n} \right)^{-1} plim \frac{W'W}{n} \left( plim \frac{X'W}{n} \right)^{-1} \right] \quad (9.43)$$

that follows from considering separately the limits of the two elements of the product and applying the previous results.

Analogously to (9.36) we have

$$E(w_t x'_t | \mathfrak{S}_t) = w_t E(x'_t | \mathfrak{S}_t) \quad (9.44)$$

because  $w_t$  is  $\sigma(\mathfrak{S}_t)$  - *measurable*; roughly speaking, when  $\mathfrak{S}_t$  is known, also  $w_t$  is known, thus it can be *moved outside* conditional expectation. However it must be noticed that, unlike (9.36), here  $w_t$  and  $E(x_t | \mathfrak{S}_t)$  are *random variables*.

A new simbol must be introduced to indicate the matrix whose  $t$ -th row is  $E(x'_t | \mathfrak{S}_t)$

$$E_{\mathfrak{S}}(X) = \begin{bmatrix} E(x_{1,1} | \mathfrak{S}_1) & E(x_{1,2} | \mathfrak{S}_1) & \dots & E(x_{1,k} | \mathfrak{S}_1) \\ E(x_{2,1} | \mathfrak{S}_2) & E(x_{2,2} | \mathfrak{S}_2) & \dots & E(x_{2,k} | \mathfrak{S}_2) \\ \dots & \dots & \dots & \dots \\ E(x_{t,1} | \mathfrak{S}_t) & E(x_{t,2} | \mathfrak{S}_t) & \dots & E(x_{t,k} | \mathfrak{S}_t) \\ \dots & \dots & \dots & \dots \\ E(x_{n,1} | \mathfrak{S}_n) & E(x_{n,2} | \mathfrak{S}_n) & \dots & E(x_{n,k} | \mathfrak{S}_n) \end{bmatrix} = \begin{bmatrix} E(x'_1 | \mathfrak{S}_1) \\ E(x'_2 | \mathfrak{S}_2) \\ \dots \\ E(x'_t | \mathfrak{S}_t) \\ \dots \\ E(x'_n | \mathfrak{S}_n) \end{bmatrix} \quad (9.45)$$

Notice that in each row the expectation is conditional on a *different*, time varying information set.

Analogously to (9.37) we have

$$plim \frac{W'X}{n} = plim \frac{W'E_{\mathfrak{S}}(X)}{n} \quad (9.46)$$

This can be proved observing that  $plim W'X/n = plim \sum_{t=1}^n w_t x'_t / n$  (applying some *suitable* WLLN)  $= \lim \sum_{t=1}^n E(w_t x'_t) / n$  (thus it is not random; we assume that the limit exists, and is a finite non-singular matrix. Applying now iterated expectations)  $= \lim \sum_{t=1}^n E[E(w_t x'_t | \mathfrak{S}_t)] / n$  (applying 9.44)  $= \lim \sum_{t=1}^n E[w_t E(x'_t | \mathfrak{S}_t)] / n$  (WLLN)  $= plim \sum_{t=1}^n w_t E(x'_t | \mathfrak{S}_t) / n = plim W'E_{\mathfrak{S}}(X)/n$ .

Applying (9.46), the asymptotic variance-covariance matrix in (9.43) can be written as

$$\sigma^2 \left( plim \frac{W'X}{n} \right)^{-1} plim \frac{W'W}{n} \left( plim \frac{X'W}{n} \right)^{-1} = \sigma^2 \left( plim \frac{W'E_{\mathfrak{S}}(X)}{n} \right)^{-1} plim \frac{W'W}{n} \left( plim \frac{E_{\mathfrak{S}}(X')W}{n} \right)^{-1} \quad (9.47)$$

Choosing  $W = E_{\mathfrak{S}}(X)$ , that is, at time  $t$ ,  $w_t = E(x_t | \mathfrak{S}_t)$ , the above asymptotic variance-covariance matrix becomes

$$\sigma^2 \left( plim \frac{E_{\mathfrak{S}}(X')E_{\mathfrak{S}}(X)}{n} \right)^{-1} \quad (9.48)$$

which is the *smallest possible*, being for any other choice of  $W$

$$\sigma^2 \left( plim \frac{W'E_{\mathfrak{S}}(X)}{n} \right)^{-1} plim \frac{W'W}{n} \left( plim \frac{E_{\mathfrak{S}}(X')W}{n} \right)^{-1} \geq \sigma^2 \left( plim \frac{E_{\mathfrak{S}}(X')E_{\mathfrak{S}}(X)}{n} \right)^{-1} \quad (9.49)$$

according to Schwarz inequality; this is analogous to (9.40).

Thus  $W = E_{\mathfrak{S}}(X)$  can be called the matrix of *efficient instrumental variables*.

Notice that, being this the most efficient choice in the new class of instrumental variables, that include the *previous* instrumental variables (non-random) as a subset, it must be *more* efficient than (or at least as efficient as) the previous choice. This follows also considering directly that

$$\left( \text{plim} \frac{E_{\mathfrak{Z}}(X')E_{\mathfrak{Z}}(X)}{n} \right)^{-1} \leq \left( \lim \frac{E(X')E(X)}{n} \right)^{-1} \quad (9.50)$$

because  $\text{plim} E_{\mathfrak{Z}}(X')E_{\mathfrak{Z}}(X)/n = \text{plim} \sum_{t=1}^n [E(x_t|\mathfrak{Z}_t)E(x'_t|\mathfrak{Z}_t)]/n = \lim \sum_{t=1}^n E[E(x_t|\mathfrak{Z}_t)E(x'_t|\mathfrak{Z}_t)]/n$  (each term of the sum is the “expectation of a square”, that is always  $\geq$  the “square of the expectation”)  $\geq \lim \sum_{t=1}^n E[E(x_t|\mathfrak{Z}_t)]E[E(x'_t|\mathfrak{Z}_t)]/n = \lim \sum_{t=1}^n E(x_t)E(x'_t)/n = \lim E(X')E(X)/n$ . The variance-covariance matrices are obtained inverting the expressions, so that the inequality would be inverted, as in (9.50).

To conclude, we observe that if a regressor at time  $t$  (an element of  $x_t$ ) is exogenous or lagged endogenous (thus it is an element of  $z_t$ ), it coincides with its conditional expectation, given  $\mathfrak{Z}_t$ , because all elements of  $z_t$  belong to  $\mathfrak{Z}_t$ . Thus it remains unchanged in the vector of efficient instrumental variables  $w_t$ . If a regressor at time  $t$  is a *current* endogenous, its conditional expectation, given  $\mathfrak{Z}_t$ , follows immediately from the reduced form:  $y_t = \Pi z_t + v_t$ , thus  $E[y_t|\mathfrak{Z}_t] = \Pi z_t$ .

In all cases we obtain as efficient instrumental variables the same values that would be obtained by treating exogenous variables and lagged endogenous variables *as if they were non-random*. In such a case, in fact, we could simply say that  $z_t = E[z_t]$ , with a notational simplification over  $E[z_t|\mathfrak{Z}_t]$ ; also, we can say that  $\Pi z_t = E[y_t]$ , with a notational simplification over  $E[y_t|\mathfrak{Z}_t]$ . This suggest to adopt a *trick* (9.4) to simplify notations.

#### 9.4 A simplification trick

What has been proved above is that, if we treat exogenous and lagged endogenous variables *as if they were non-random variables*, the main results remain valid, with a considerable simplification of notations.

Let's consider an equation where a *current endogenous* variable is among the regressors (an endogenous variable at time  $t$  is one of the elements of the vector  $x_t$ ). For example, in the first structural equation of the Klein-I model (the private consumption equation)

$$C_t = \alpha_1 + \alpha_2 P_t + \alpha_3 P_{t-1} + \alpha_4 W_t + u_{1,t}$$

the vector of regressors (explanatory variables) at time  $t$  is  $x_t = [1, P_t, P_{t-1}, W_t]'$ . Current profits ( $P_t$ ) is the second regressor of  $C_t$  in the structural form. In the *reduced form* system  $y_t = \Pi z_t + v_t$ , the equation of  $P_t$  is the 5th, being  $P_t$  the 5th element of the  $7 \times 1$  vector  $y_t$ . Therefore  $P_t = [y_t]_5 = \Pi_{5,\bullet} z_t + v_{5,t}$ , being  $\Pi_{5,\bullet}$  the 5th row of the  $7 \times 8$  matrix  $\Pi$ . Since  $\mathfrak{Z}_t$  contains all the elements of  $z_t$ , it is,  $E[P_t|\mathfrak{Z}_t] = \Pi_{5,\bullet} z_t$ . Exactly the same value would be obtained using the *simplification trick*:  $E[P_t] = \Pi_{5,\bullet} z_t$ , because  $z_t$  contains only exogenous and lagged endogenous variables (thus *nonrandom*), and the error term  $v_{5,t}$  has zero mean. Thus the vector of *efficient instrumental variables* at time  $t$ ,  $w_t = E(x_t)$ , should contain, as a second element,  $E[P_t] = \Pi_{5,\bullet} z_t$ .

We do analogously for the fourth element of the vector  $w_t$ , that should be filled by  $E[W_t] = \Pi_{7,\bullet} z_t$ , being *total wages and salaries* the 7th endogenous variable of the model.

The first (1) and the third ( $P_{t-1}$ ) element of the vector  $w_t$  are equal to the corresponding elements of  $x_t$ , because they are *nonrandom* (simplification trick).

Notice finally that being  $[P_t] = \Pi_{5,\bullet} z_t + v_{5,t}$ , the scalar  $E[P_t] = \Pi_{5,\bullet} z_t$  can be viewed as a linear combination of the elements of  $z_t$ , but also as the observed value of the endogenous variable  $P_t$  *purged* of its reduced form error  $E[P_t] = P_t - v_{5,t}$ .

In all the formulas that follow,  $E(X)$  implicitly means  $E_{\mathfrak{Z}}(X)$ , and *expectation* implicitly means *conditional expectation*.

#### 9.5 Instrumental variables for Klein-I model

The model has 3 stochastic behavioural equations. We call  $X_1$  the  $(n \times k_1)$  matrix of the explanatory variables in the structural form equation of consumption.  $X_2$  ( $n \times k_2$ ) and  $X_3$  ( $n \times k_3$ ) are the matrices of explanatory variables in the structural form equations of investment and private wages, respectively. For this particular model the three matrices have the same dimensions ( $21 \times 4$ ). The  $t$ -th row of these matrices are as follows

$$\begin{array}{lll} x'_{1t} = [1 & P_t & P_{t-1} & W_t] & x'_{2t} = [1 & P_t & P_{t-1} & K_{t-1}] & x'_{3t} = [1 & X_t & X_{t-1} & A_t] \\ (1 \times k_1) & & (1 \times k_2) & & (1 \times k_3) \end{array}$$

The matrices  $W_1$ ,  $W_2$  and  $W_3$  have the same dimensions as the corresponding matrices  $X_1$ ,  $X_2$  and  $X_3$ . Their  $t$ -th rows are as follows

$$\begin{array}{lll} w'_{1t} = [1 & \Pi_{5,\bullet} z_t & P_{t-1} & \Pi_{7,\bullet} z_t] & w'_{2t} = [1 & \Pi_{5,\bullet} z_t & P_{t-1} & K_{t-1}] & w'_{3t} = [1 & \Pi_{4,\bullet} z_t & X_{t-1} & A_t] \\ (1 \times k_1) & & (1 \times k_2) & & (1 \times k_3) \end{array}$$

#### 9.6 Feasible instrumental variable estimator

Unfortunately, the method discussed above is asymptotically efficient just in principle; in practice the method is *not feasible*. To make the method *feasible*, we shall replace the  $(n \times k)$  matrix  $E(X)$  with a matrix that contains *good* estimates of the expected values of the elements of  $X$ . So, in practice, we shall use as a matrix of instrumental variables

$$W = E(\widehat{X}) \quad (9.51)$$

More or less all the estimation methods proposed in the literature use instrumental variables of this type (9.51). The differences from one another are due to different ways of computing the *estimated expected values*  $E(\widehat{X})$ .

Concerning the consumption equation, being  $\Pi$  (and therefore  $\Pi_{5,\bullet}$ ) unknown, to make the estimation method *feasible* in practice we first estimate  $\Pi$  (or at least  $\Pi_{5,\bullet}$ ), obtaining  $\widehat{\Pi}$ , and then plug into  $w_t$ , as its second element, the scalar  $E[\widehat{P}_t] = \widehat{\Pi}_{5,\bullet} z_t$ .

If a *consistent* estimator of  $\Pi$  is used to build the matrix of instrumental variables, then the resulting *feasible* instrumental variable estimator has the same asymptotic variance-covariance matrix as the *not feasible* efficient estimator (the one that would use the *true* matrix  $\Pi$ ).

To prove it, we can consider how the estimation error (eq. 9.35) changes if we use  $W = E(X)$  (the *not feasible* estimator that uses the *true*  $\Pi$ ) or if we use  $W = E(\widehat{X})$  (the *feasible* estimator that uses a consistent estimator  $\widehat{\Pi}$ ). Let's first consider the  $(k \times k)$  matrix  $W'X/n$  of equation (9.35). It has exactly the same *plim* whether we use  $W = E(X)$ , or we use  $W = E(\widehat{X})$

$$\text{plim} \left( \frac{E(X')X}{n} \right) = \text{plim} \left( \frac{E(\widehat{X}')X}{n} \right)$$

The above equality can be easily proved element by element. For example, still with reference to the consumption equation of the Klein-I model, the element (1,2) of such a matrix is  $\sum_{t=1}^n E(P_t)/n = \sum_{t=1}^n \Pi_{5,\bullet} z_t/n = \Pi_{5,\bullet} (\sum_{t=1}^n z_t/n)$  in the *not feasible* case, while in the *feasible* case it is  $\sum_{t=1}^n E(\widehat{P}_t)/n = \sum_{t=1}^n \widehat{\Pi}_{5,\bullet} z_t/n = \widehat{\Pi}_{5,\bullet} (\sum_{t=1}^n z_t/n)$ . The two expressions have obviously the same limit if  $\text{plim} \widehat{\Pi}_{5,\bullet} = \Pi_{5,\bullet}$ .

Analogously, the equality can be proved for all the other elements of the  $(k \times k)$  matrix ( $4 \times 4$ , in the example).

Considering now the  $(k \times 1)$  vector  $W'u/\sqrt{n}$  in equation (9.35), again it is straightforward to verify that each element converges to the same distribution whether we use  $W = E(X)$ , or we use  $W = E(\widehat{X})$ .

We conclude, therefore, that also the *feasible* estimator is asymptotically efficient.

## 10 LIMITED INFORMATION ESTIMATION METHODS (or Single Equation Estimation Methods)

Most of the different *traditional* estimation methods of the literature are based on equation (8.29), with different ways of computing the feasible  $W = E(\widehat{X})$  (more precisely,  $W = E_{\mathfrak{S}}(\widehat{X})$ ). Its computation always uses a *previously computed* estimator ( $\widehat{\Pi}$ ) of the matrix of reduced form coefficients, such that  $\text{plim} \widehat{\Pi} = \Pi$  (consistent estimator of  $\Pi$ ). All estimation methods are performed in several *stages* (or steps, two or more than two): the final stage is always equation (8.29), while the previous stages aim at providing a consistent estimator of  $\Pi$ .

Limited information methods do not exploit information contained in the correlation between error terms of different equations.

### 10.1 2SLS - Two Stage Least Squares: Basmann (1957), Theil (1958)

We first select all the *current* endogenous variables appearing somewhere on the right hand side of the structural form equations. Then we regress, with OLS, each of these current endogenous variables against *all the exogenous and lagged endogenous variables* of the system (*first stage*). The *fitted* values of these variables are used in the matrices of instrumental variables, where exogenous and lagged endogenous variables are left at their observed value. Then we apply the instrumental variables formula (8.29) to each structural form equation (*second stage*).

The first stage is an OLS estimation of each reduced form equations, *unrestricted*. Each OLS provides a consistent estimate of a row of  $\Pi$ , since the variables on the right hand side of each equation are only exogenous and lagged endogenous variables. The *fitted* values of the dependent variables can therefore be used in the matrices of instrumental variables, to *replace the current endogenous regressors* of the structural form equations.

Having built the matrices of instrumental variables *in this particular way*, the results remain *algebraically equal* if, instead of the I.V. formula, in the second stage we again apply the OLS formula. For instance, in the first equation,  $W_1'X_1 = W_1'W_1$ , thus  $(W_1'X_1)^{-1}W_1'y_1 = (W_1'W_1)^{-1}W_1'y_1$ . For this reason the method is called *two stage least squares*.

2SLS is perhaps the most *popular* among limited information methods. It cannot be applied to large scale systems. In fact, when the number of exogenous and lagged endogenous variables in the system is too large ( $> n$ ), the first stage OLS estimation is not feasible.

### 10.2 LIVE - Limited information Instrumental Variables Efficient: Brundy and Jorgenson (1971), Dhrymes (1971)

In the first stage of this method some *arbitrary* matrices of instrumental variables are used, and equation (8.29) is applied to each structural form equation. In the example, we use three matrices  $W_1$ ,  $W_2$  and  $W_3$  that only need to satisfy the quite general requirements for the matrices of instrumental variables given in section 8.

This first stage provides, for each structural form equation, coefficient estimates which are consistent, but not asymptotically efficient. Estimated coefficients are then *plugged into* the matrices of structural form coefficients, producing a consistent (but inefficient) estimate of  $B$  and  $\Gamma$ .

Inverting the estimated  $B$  and multiplying by the estimated  $\Gamma$  (with minus sign) provides a consistent estimate of the matrix of reduced form coefficients  $\Pi$ . This estimate of  $\Pi$  is now used to build, for each equation, the matrix of the estimated expected values of the regressors, to be used as new matrices of instrumental variables (as in section 9.5 for the example model).

Then the second stage applies equation (8.29) to each structural form equation, producing coefficient estimates which are consistent and asymptotically efficient.

Unlike 2SLS, this method estimates  $\Pi$  from the *restricted* reduced form. The *estimation formula* is only applied to the structural form equations, (usually with a *small* number of regressors), thus the method can be applied also to large scale models. It is, however, less *robust* than 2SLS. A specification error in a structural form equation may have consequences in the estimation of the other equations as well, even if correctly specified. This does not happen for 2SLS, where a specification error in one equation has consequences only for such equation.

Notice finally that the estimated expected values of the endogenous regressors, to be used in the i.v. matrices of the second stage, are the values of the endogenous variables computed from the simultaneous solution of the structural form model, using the terminology of section 5. Solution is, of course, static (or one-step-ahead), since lagged endogenous are considered fixed (section 9.4).

The instrumental variables used in the first stage can be completely arbitrary, as already observed. A simple technique is customarily (even if not necessarily) adopted to build them. A preliminary estimation is done, using OLS on the structural form equations. Estimates would therefore be inconsistent, but *presumably better* than if we *invent* them from scratch. From these estimates, filling the matrices  $B$  and  $\Gamma$  we compute an estimate of  $\Pi$  (still inconsistent, of course), and use it to fill the matrices of instrumental variables to be used in the first stage. Then, first and second stage are as above.

### 10.3 IIV - Iterative Instrumental Variables: Dutta and Lyttkens (1974), Lyttkens (1974)

The final stage of LIVE can be applied iteratively, till convergence is achieved. At the end of each iteration, estimated coefficients are *plugged into* the matrices  $B$  and  $\Gamma$ ; a new estimate of  $\Pi$  is then computed; new matrices of instrumental variables are then computed and used in the next iteration.

Each new iteration (or stage) may change the numerical values of the estimates, but not their asymptotic distribution: efficiency has been already achieved at the second stage.

### 10.4 $k$ -class Estimator: Theil (1958), Nagar (1959)

It is convenient here to interpret the instrumental variables as at the end of section 9.4, that is the observed value of each regressor *purged* of its reduced form error.

With reference to the first structural form equation of the example model, we may replace  $P_t$ , in the matrix of instrumental variables, with  $P_t - k \hat{v}_{5,t}$ , where  $k$  is a scalar random variable, function of the data. Analogously, we replace  $W_t$  with  $W_t - k \hat{v}_{7,t}$ . If  $\hat{v}_{5,t}$  and  $\hat{v}_{7,t}$  are residuals of OLS applied to the unrestricted reduced form (as in the first stage of 2SLS), the instrumental variable estimator is called  $k$ -class estimator. It is straightforward to prove that the estimator is consistent if  $\text{plim } (k - 1) = 0$ , and also asymptotically efficient if  $\text{plim } \sqrt{n} (k - 1) = 0$ . Roughly speaking,  $k$  must converge to 1 *fast enough*.

2SLS is the particular case when  $k = 1$ ; as well known, it is consistent and asymptotically efficient. OLS is the particular case when  $k = 0$ , and it is inconsistent.

### 10.5 GIVE - Generalized Instrumental Variable Estimator: Sargan (1958)

### 10.6 LIML - Limited Information Maximum Likelihood: Anderson and Rubin (1949, 1950)

## 11 SEEMINGLY UNRELATED REGRESSION EQUATIONS (SURE)

A system of  $G$  linear regression models, *without* endogenous regressors,

$$\begin{aligned} \begin{bmatrix} y_1 \\ \dots \\ y_i \\ \dots \\ y_G \end{bmatrix} &= \begin{bmatrix} X_1 \beta_1 + u_1 \\ \dots \\ X_i \beta_i + u_i \\ \dots \\ X_G \beta_G + u_G \end{bmatrix} \quad \text{where} \quad y_i = \begin{bmatrix} y_{i,1} \\ y_{i,2} \\ \dots \\ y_{i,t} \\ \dots \\ y_{i,n} \end{bmatrix} \quad X_i = \begin{bmatrix} x_{i,1,1} & x_{i,1,2} & \dots & x_{i,1,k_i} \\ x_{i,2,1} & x_{i,2,2} & \dots & x_{i,2,k_i} \\ \dots & \dots & \dots & \dots \\ x_{i,t,1} & x_{i,t,2} & \dots & x_{i,t,k_i} \\ \dots & \dots & \dots & \dots \\ x_{i,n,1} & x_{i,n,2} & \dots & x_{i,n,k_i} \end{bmatrix} \quad \beta_i = \begin{bmatrix} \beta_{i,1} \\ \beta_{i,2} \\ \dots \\ \beta_{i,k_i} \end{bmatrix} \\ u_i &= \begin{bmatrix} u_{i,1} \\ u_{i,2} \\ \dots \\ u_{i,t} \\ \dots \\ u_{i,n} \end{bmatrix} \quad \begin{cases} E[u_{i,t}] = 0 \quad \forall i, t \\ V[u_{i,t}] = \sigma_i^2 = \sigma_{i,i} \quad \forall t \\ Cov[u_{i,t}, u_{j,t}] = \sigma_{i,j} \quad \forall t \\ Cov[u_{i,t_1}, u_{j,t_2}] = 0 \quad \forall i, j, t_1 \neq t_2 \end{cases} \end{aligned} \quad (11.52)$$

can be represented as a *single* linear regression model,  $y = X\beta + u$  with  $Gn$  observations, defining the vectors and matrices

$$y = X\beta + u \quad \begin{matrix} y = \\ (Gn \times 1) \end{matrix} \begin{bmatrix} y_1 \\ y_2 \\ \dots \\ y_i \\ \dots \\ y_G \end{bmatrix} \quad \begin{matrix} X = \\ [Gn \times (k_1 + \dots + k_G)] \end{matrix} \begin{bmatrix} X_1 & 0 & \dots & 0 \\ 0 & X_2 & \dots & 0 \\ \dots & \dots & \dots & \dots \\ 0 & \dots & X_i & 0 \\ \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & X_G \end{bmatrix} \quad \begin{matrix} \beta = \\ [(k_1 + \dots + k_G) \times 1] \end{matrix} \begin{bmatrix} \beta_1 \\ \beta_2 \\ \dots \\ \beta_i \\ \dots \\ \beta_G \end{bmatrix} \quad \begin{matrix} u = \\ (Gn \times 1) \end{matrix} \begin{bmatrix} u_1 \\ u_2 \\ \dots \\ u_i \\ \dots \\ u_G \end{bmatrix} \quad (11.53)$$

where the vector of error terms, with  $Gn$  elements, has expected value zero and variance-covariance matrix

$$V(u) = \Sigma \otimes I_n = \begin{matrix} \Sigma \\ (Gn \times Gn) \end{matrix} \otimes \begin{matrix} I_n \\ (n \times n) \end{matrix} = \begin{bmatrix} \sigma_{1,1} & 0 & \dots & 0 & \sigma_{1,2} & 0 & \dots & 0 & \dots & \sigma_{1,G} & 0 & \dots & 0 \\ 0 & \sigma_{1,1} & \dots & 0 & 0 & \sigma_{1,2} & \dots & 0 & \dots & 0 & \sigma_{1,G} & \dots & 0 \\ \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & \sigma_{1,1} & 0 & 0 & \dots & \sigma_{1,2} & \dots & 0 & 0 & \dots & \sigma_{1,G} \\ \sigma_{2,1} & 0 & \dots & 0 & \sigma_{2,2} & 0 & \dots & 0 & \dots & \sigma_{2,G} & 0 & \dots & 0 \\ 0 & \sigma_{2,1} & \dots & 0 & 0 & \sigma_{2,2} & \dots & 0 & \dots & 0 & \sigma_{2,G} & \dots & 0 \\ \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & \sigma_{2,1} & 0 & 0 & \dots & \sigma_{2,2} & \dots & 0 & 0 & \dots & \sigma_{2,G} \\ \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots \\ \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots \\ \sigma_{G,1} & 0 & \dots & 0 & \sigma_{G,2} & 0 & \dots & 0 & \dots & \sigma_{G,G} & 0 & \dots & 0 \\ 0 & \sigma_{G,1} & \dots & 0 & 0 & \sigma_{G,2} & \dots & 0 & \dots & 0 & \sigma_{G,G} & \dots & 0 \\ \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & \sigma_{G,1} & 0 & 0 & \dots & \sigma_{G,2} & \dots & 0 & 0 & \dots & \sigma_{G,G} \end{bmatrix} \quad (11.54)$$

whose inverse is  $\Sigma^{-1} \otimes I_n$ .

There is no explicit relationship among equations, since there are no current endogenous variables on the right hand side of the equations (no *simultaneity*). There is, however, a relationship due to the correlations among contemporaneous error terms (or cross-equations correlations).

### 11.1 An example of SURE model: Zellner (1962)

The model is a system of 2 equations, each with 3 explanatory variables (regressors). Dependent variables are annual gross investments of two corporations, during the period 1935-1954.

$$\begin{cases} I_t^{GE} = \beta_{1,1} + \beta_{1,2} F_{t-1}^{GE} + \beta_{1,3} C_{t-1}^{GE} + u_{1,t} & \text{General Electric} \\ I_t^W = \beta_{2,1} + \beta_{2,2} F_{t-1}^W + \beta_{2,3} C_{t-1}^W + u_{2,t} & \text{Westinghouse} \end{cases} \quad (11.55)$$

$F_{t-1}$  is the *market value of the firm*, defined as the total value of the outstanding stock at end-of-year market quotations.  $C_{t-1}$  is the existing capital stock.

### 11.2 GLS and Feasible GLS estimation of SURE models

If  $X$  does not contain random variables and  $\Sigma$  is *known*, the GLS estimator

$$\dot{\beta}_{GLS} = [X'(\Sigma^{-1} \otimes I_n)X]^{-1} X'(\Sigma^{-1} \otimes I_n)y \quad (11.56)$$

is BLUE (Aitken's theorem), as well as consistent and asymptotically efficient. The variance-covariance matrix of the GLS estimator is

$$Var(\dot{\beta}_{GLS}) = E[(\dot{\beta}_{GLS} - \beta)(\dot{\beta}_{GLS} - \beta)'] = [X'(\Sigma^{-1} \otimes I_n)X]^{-1} \quad (11.57)$$

If  $\Sigma$  is not known, a *feasible* GLS estimator can be obtained from the same equation, having previously computed a consistent estimate  $\hat{\Sigma}$ .  $\hat{\Sigma}$  is usually computed from residuals of a preliminary OLS estimation; it is consistent, being OLS consistent for a model without endogenous regressors. It is common practice to compute  $\hat{\Sigma}$  without *degrees of freedom correction*, that is dividing by  $n$  the sums of squared residuals (variances) or the sums of cross products of contemporaneous residuals (covariances).

$$\dot{\beta}_{FGLS} = [X'(\hat{\Sigma}^{-1} \otimes I_n)X]^{-1} X'(\hat{\Sigma}^{-1} \otimes I_n)y \quad (11.58)$$

If  $plim \hat{\Sigma} = \Sigma$ , both estimation errors (rescaled by  $\sqrt{n}$ ) have the same asymptotic distribution (multivariate normal)

$$\begin{aligned} \sqrt{n} [\dot{\beta}_{GLS} - \beta] &= \left[ \frac{X'(\Sigma^{-1} \otimes I_n)X}{n} \right]^{-1} \frac{X'(\Sigma^{-1} \otimes I_n)u}{\sqrt{n}} \\ \sqrt{n} [\dot{\beta}_{FGLS} - \beta] &= \left[ \frac{X'(\hat{\Sigma}^{-1} \otimes I_n)X}{n} \right]^{-1} \frac{X'(\hat{\Sigma}^{-1} \otimes I_n)u}{\sqrt{n}} \end{aligned} \quad \xrightarrow[n \rightarrow \infty]{distr} N \left\{ 0, \left[ \frac{X'(\Sigma^{-1} \otimes I_n)X}{n} \right]^{-1} \right\} \quad (11.59)$$

Each estimation error, in fact, is the product of two terms: the first term of the product has the same limit, in the two cases; the second term of the product has, in the two cases, the same asymptotic normal distribution.

### 11.3 Remarks and special cases

1. Kronecker product is a convenient algebraic operator that permits a closed form representation of the variance-covariance matrix. Its use, however, is *not recommended* in the computational practice. Software algorithms should avoid its use, because of its computational inefficiency.

Indicating with  $\hat{\sigma}^{i,j}$  the generic element of  $\hat{\Sigma}^{-1}$ , it is easier and faster to compute the matrix  $[X'(\hat{\Sigma}^{-1} \otimes I_n)X]$  block by block, the  $i, j - th$  block being  $\hat{\sigma}^{i,j} X'_i X_j$  (of dimensions  $k_i \times k_j$ ).

The vector  $X'(\hat{\Sigma}^{-1} \otimes I_n)y$  would be analogously partitioned, the  $i - th$  sub-vector being  $X'_i \sum_{j=1}^G \hat{\sigma}^{i,j} y_j$ .

2. GLS (or Feasible GLS) obviously gives the same results as OLS (algebraically and numerically) when  $\Sigma$  (or  $\hat{\Sigma}$ ) is diagonal (all cross equation covariances are zero).
3. Even if  $\Sigma$  (or  $\hat{\Sigma}$ ) is not diagonal (cross equation covariances are not zero), GLS (or Feasible GLS) gives the same results as OLS (algebraically and numerically) if the explanatory variables (regressors) are the same in each equation. In such a case, if we call  $Z$  the  $(n \times k)$  matrix of explanatory variables common to all equations, then the block-diagonal matrix  $X$  could be represented as  $X = I_G \otimes Z$  (with dimensions  $Gn \times Gk$ ), and some straightforward algebra would give

$$\begin{aligned} \dot{\beta}_{FGLS} &= [X'(\hat{\Sigma}^{-1} \otimes I_n)X]^{-1} X'(\hat{\Sigma}^{-1} \otimes I_n)y = [(I_G \otimes Z)'(\hat{\Sigma}^{-1} \otimes I_n)(I_G \otimes Z)]^{-1} (I_G \otimes Z)'(\hat{\Sigma}^{-1} \otimes I_n)y \\ &= \{I_G \otimes [(Z'Z)^{-1}Z']\}y = \begin{bmatrix} \hat{\beta}_{OLS_1} \\ \vdots \\ \hat{\beta}_{OLS_i} \\ \vdots \\ \hat{\beta}_{OLS_G} \end{bmatrix} \end{aligned} \quad (11.60)$$

4. As a final remark, it can be shown that, with a simple transformation, current endogenous regressors appear explicitly, while they seem to be absent from (11.52), thus explaining why the equations are unrelated only *seemingly* and not really. If the contemporaneous error terms  $u_t$ , in a 2 equations model, have a bivariate normal distribution

$$\begin{bmatrix} y_{1,t} \\ y_{2,t} \end{bmatrix} = \begin{bmatrix} x'_{1,t}\beta_1 \\ x'_{2,t}\beta_2 \end{bmatrix} + \begin{bmatrix} u_{1,t} \\ u_{2,t} \end{bmatrix} \quad \text{where} \quad \begin{bmatrix} u_{1,t} \\ u_{2,t} \end{bmatrix} \sim N[0, \Sigma] \quad \text{therefore} \quad \begin{bmatrix} u_{1,t} \\ u_{2,t}|u_{1,t} \end{bmatrix} \sim \begin{bmatrix} N[0, \sigma_{1,1}] \\ N\left[\frac{\sigma_{1,2}}{\sigma_{1,1}} u_{1,t}, \sigma_{2,2} - \frac{\sigma_{1,2}^2}{\sigma_{1,1}}\right] \end{bmatrix}$$

we can write

$$\begin{bmatrix} u_{1,t} \\ u_{2,t} \end{bmatrix} = \begin{bmatrix} \sqrt{\sigma_{1,1}} e_{1,t} \\ \frac{\sigma_{1,2}}{\sigma_{1,1}} u_{1,t} + \sqrt{\sigma_{2,2} - \frac{\sigma_{1,2}^2}{\sigma_{1,1}}} e_{2,t} \end{bmatrix} \quad \text{where} \quad \begin{bmatrix} e_{1,t} \\ e_{2,t} \end{bmatrix} \sim N[0, I_2]$$

Replacing  $u_{1,t} = y_{1,t} - x'_{1,t}\beta_1$  into the expression of  $u_{2,t}$ , then the two equations become

$$\begin{bmatrix} y_{1,t} \\ y_{2,t} \end{bmatrix} = \begin{bmatrix} x'_{1,t}\beta_1 \\ x'_{2,t}\beta_2 \end{bmatrix} + \begin{bmatrix} \sqrt{\sigma_{1,1}} e_{1,t} \\ \frac{\sigma_{1,2}}{\sigma_{1,1}} (y_{1,t} - x'_{1,t}\beta_1) + \sqrt{\sigma_{2,2} - \frac{\sigma_{1,2}^2}{\sigma_{1,1}}} e_{2,t} \end{bmatrix}$$

where an endogenous regressor explicitly appears in the second equation. Notice that, after transformation, the error terms are no more correlated; a system of this type is called “recursive”.

### 11.4 Iterative Feasible GLS and Maximum Likelihood

Feasible GLS (11.58) can be applied *iteratively*, each time re-computing an estimate of  $\Sigma$  from residuals of the last iteration. Let  $\dot{\beta}_{FGLS(m)}$  be the coefficient estimates at the end of iteration  $m$ ,  $\dot{u}_{FGLS(m)}$  the corresponding residuals and  $\dot{\Sigma}_{FGLS(m)}$  the variance-covariance matrix computed from residuals. It is therefore  $y = X \dot{\beta}_{FGLS(m)} + \dot{u}_{FGLS(m)}$ , that can be introduced into equation (11.58) to replace  $y$ , obtaining

$$\begin{aligned} \dot{\beta}_{FGLS(m+1)} &= [X'(\dot{\Sigma}_{FGLS(m)}^{-1} \otimes I_n)X]^{-1} X'(\dot{\Sigma}_{FGLS(m)}^{-1} \otimes I_n)(X \dot{\beta}_{FGLS(m)} + \dot{u}_{FGLS(m)}) \\ &= \dot{\beta}_{FGLS(m)} + [X'(\dot{\Sigma}_{FGLS(m)}^{-1} \otimes I_n)X]^{-1} X'(\dot{\Sigma}_{FGLS(m)}^{-1} \otimes I_n)\dot{u}_{FGLS(m)} \end{aligned} \quad (11.61)$$

Convergence is achieved when  $\dot{\beta}_{FGLS(m+1)} = \dot{\beta}_{FGLS(m)}$ , therefore when  $X'(\dot{\Sigma}_{FGLS(m)}^{-1} \otimes I_n)\dot{u}_{FGLS(m)} = 0$ . This expression is the *gradient of the concentrated log-likelihood*, under the additional assumption that the error terms have a multivariate normal distribution. Thus, iterative feasible GLS converges to maximum likelihood (ML). Proof is in Appendix (13). Notice that (11.59) holds for each iteration, therefore the asymptotic efficiency is the same at each iteration, as well as when convergence is achieved.

## 12 FULL INFORMATION ESTIMATION METHODS (or System Estimation Methods)

Matrix  $\Sigma$  is completely *ignored* by limited information methods, but it may contain useful information, that may improve the estimator's efficiency. Full information methods take into account also this information.

### 12.1 Remark

It must be noticed that estimation concerns only the behavioural *stochastic* equations of the model (the first three equations, in the example). What is called  $\Sigma$  in this section is therefore the variance-covariance matrix of the error terms, at time  $t$ , of the stochastic equations only, excluding the identities. In the example, it is the  $3 \times 3$  positive definite matrix previously called  $\Sigma_3$  (equation 3.5), and not the full  $7 \times 7$  matrix that, being singular, could not be inverted. The whole system of 7 equations must be considered when computing expected values of endogenous regressors (or reduced form coefficients, or simultaneous solution of the system). For calculations involving residuals, like estimation of the  $\Sigma$  matrix, only the 3 stochastic equations must be considered.

### 12.2 Efficient instrumental variables in the full information context

We first decompose the positive definite variance-covariance matrix as the product of a non-singular square matrix  $P$  with its transpose:  $\Sigma \otimes I_n = P'P$ , so that  $\Sigma^{-1} \otimes I_n = P^{-1}P'^{-1}$ . Equations, coefficients, variables and error terms are represented as in section 11, but in some or all  $G$  equations the matrices of regressors,  $X_1, X_2, \dots, X_G$ , may contain current endogenous variables. We build, therefore, the corresponding matrices of instrumental variables  $W_1, W_2, \dots, W_G$ , containing the same variables, but with current endogenous variables replaced by their expected values (conditional expectations, to be more precise).

The matrices of instrumental variables  $W_1, W_2, \dots, W_G$  are used as blocks of the matrix  $W$ , while the matrices of explanatory variables (regressors)  $X_1, X_2, \dots, X_G$  are used as blocks of the matrix  $X$

$$W = \begin{matrix} [Gn \times (k_1 + \dots + k_G)] \end{matrix} \begin{bmatrix} W_1 & 0 & \dots & 0 \\ 0 & W_2 & \dots & 0 \\ \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & W_G \end{bmatrix} = \begin{bmatrix} E(X_1) & 0 & \dots & 0 \\ 0 & E(X_2) & \dots & 0 \\ \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & E(X_G) \end{bmatrix} = E \begin{bmatrix} X_1 & 0 & \dots & 0 \\ 0 & X_2 & \dots & 0 \\ \dots & \dots & \dots & \dots \\ 0 & 0 & \dots & X_G \end{bmatrix} = E(X) \quad (12.62)$$

Analogously to section 11, we represent the whole system as a single equation  $y = X\beta + u$  and pre-multiply each term by  $P'^{-1}$ , obtaining  $P'^{-1}y = P'^{-1}X\beta + P'^{-1}u$ . Defining  $q = P'^{-1}y$ ,  $Q = P'^{-1}X$  and  $\varepsilon = P'^{-1}u$ , the equation becomes  $q = Q\beta + \varepsilon$ , where variables and errors terms have been transformed, but coefficients are still the same as in the model of interest. Of course there will be correlation between explanatory variables  $Q$  and error terms  $\varepsilon$ .

Some simple algebra shows that the transformed error terms have zero mean and variance-covariance matrix  $I_{Gn}$ , therefore homoskedastic and not correlated. Thus, instrumental variable estimator of the transformed equation would be consistent and asymptotically efficient, if instrumental variables are the expected values of regressors

$$H = E(Q) = E(P'^{-1}X) = P'^{-1}E(X) = P'^{-1}W \quad (12.63)$$

and applying the instrumental variable formula we get

$$\check{\beta} = [H'Q]^{-1}H'q = [W'P^{-1}P'^{-1}X]^{-1}W'P^{-1}P'^{-1}y = [W'(\Sigma^{-1} \otimes I_n)X]^{-1}W'(\Sigma^{-1} \otimes I_n)y \quad (12.64)$$

Analogously to equation (11.59), considering that  $W = E(X)$ , the estimation error (rescaled by  $\sqrt{n}$ ) is

$$\sqrt{n}[\check{\beta} - \beta] = \left[ \frac{W'(\Sigma^{-1} \otimes I_n)X}{n} \right]^{-1} \frac{W'(\Sigma^{-1} \otimes I_n)u}{\sqrt{n}} \xrightarrow[n \rightarrow \infty]{\text{distr}} N \left\{ 0, \left[ \frac{W'(\Sigma^{-1} \otimes I_n)W}{n} \right]^{-1} \right\} \quad (12.65)$$

To make the estimator *feasible* we replace  $\Sigma$  with an estimate, and fill matrix  $W$  with estimates of the expected values of regressors. If the estimate of  $\Sigma$  is computed from residuals of a preliminary consistent (even if inefficient) estimation, and estimates of expected values of regressors are computed using a preliminary consistent (even if inefficient) estimate of  $\Pi$ , then the feasible estimator would have the same asymptotic distribution as the *theoretical* estimator (12.65), and would be therefore asymptotically efficient.

### 12.3 3SLS - Three Stage Least Squares: Zellner and Theil (1962)

The structural form equations of the model are first estimated by two stage least squares (2SLS), obtaining a consistent estimate of all the structural form coefficients ( $\tilde{\alpha}_1, \dots, \tilde{\alpha}_{12}$  in the example), and the corresponding residuals. Sums of squares and sums of cross products of structural residuals are used to produce  $\tilde{\Sigma}$ , a consistent estimate of  $\Sigma$ , while second stage coefficients are no more used.

Third stage is simply the application of the feasible full information estimator

$$\check{\beta} = [W'(\tilde{\Sigma}^{-1} \otimes I_n)X]^{-1}W'(\tilde{\Sigma}^{-1} \otimes I_n)y \quad (12.66)$$

where the blocks of matrix  $W$  are the same computed at the end of the first stage, and already used in the second stage.

## 12.4 Iterative Three Stage Least Squares

The final formula of 3SLS (12.66) can be applied *iteratively*, each time re-computing an estimate of  $\Sigma$  from residuals of the last iteration. Matrix  $W$  is not updated during the iterations, but remains fixed. Iterations continue till convergence is achieved.

## 12.5 FIVE - Full information Instrumental Variables Efficient: Brundy and Jorgenson (1971), Dhrymes (1971)

The first stage is the same as in the corresponding limited information method (LIVE, section 10.2). First of all it produces, for each equation, the new matrix of instrumental variables (the blocks of  $W$ ). Also residuals of the structural form equations are used to produce a consistent estimate of  $\Sigma$ .

The next (final) stage is simply the application of the feasible full information estimator (analogous to 12.66).

## 12.6 FIML - Full Information Maximum Likelihood: Koopmans, Rubin and Leipnik (1950), Chernoff and Divinsky (1953)

## 12.7 FIML from iterative instrumental variables: Durbin (1963, 1988), Hausman (1974, 1975)

The last stage of FIVE can be applied *iteratively*, each time re-computing estimates of  $B$  and  $\Gamma$ , from which a new estimate of  $\Pi$  and new matrices of instrumental variables are derived, and re-estimating  $\Sigma$  from structural form residuals. Let  $\check{\beta}_{(m)}$  be the coefficient estimates at the end of iteration  $m$ ,  $W_{(m)}$  the matrix of instrumental variables built by means of such coefficients,  $\check{u}_{(m)}$  the corresponding residuals and  $\check{\Sigma}_{(m)}$  the variance-covariance matrix computed from residuals. It is therefore  $y = X \check{\beta}_{(m)} + \check{u}_{(m)}$ , that can be introduced into equation (12.66) to replace  $y$ , obtaining

$$\begin{aligned}\check{\beta}_{(m+1)} &= \left[ W'_{(m)} \left( \check{\Sigma}_{(m)}^{-1} \otimes I_n \right) X \right]^{-1} W'_{(m)} \left( \check{\Sigma}_{(m)}^{-1} \otimes I_n \right) \left( X \check{\beta}_{(m)} + \check{u}_{(m)} \right) \\ &= \check{\beta}_{(m)} + \left[ W'_{(m)} \left( \check{\Sigma}_{(m)}^{-1} \otimes I_n \right) X \right]^{-1} W'_{(m)} \left( \check{\Sigma}_{(m)}^{-1} \otimes I_n \right) \check{u}_{(m)}\end{aligned}\tag{12.67}$$

Convergence is achieved when  $\check{\beta}_{(m+1)} = \check{\beta}_{(m)}$ , therefore when  $W'_{(m)} \left( \check{\Sigma}_{(m)}^{-1} \otimes I_n \right) \check{u}_{(m)} = 0$ . This expression is the *gradient of the concentrated log-likelihood*, under the additional assumption that the error terms have a multivariate normal distribution. Proof is in Appendix (14). Thus, iterative FIVE converges to full information maximum likelihood (FIML).

Notice that (11.59) holds for each iteration, therefore the asymptotic efficiency is the same at each iteration, as well as when convergence is achieved.

This method for computing FIML estimates was proposed by Durbin in 1963 (published in 1988), discussed in Hausman (1974, 1975), Hendry (1976), Calzolari and Sampoli (1993), and extended to nonlinear models in Amemiya (1977).

## 13 APPENDIX

## 14 APPENDIX



# 15 APPENDIX. Data set and numerical results for Klein-I model

|      | C    | I    | Wp   | X    | P    | K     | W    | 1   | Wg  | T    | A    | G    |
|------|------|------|------|------|------|-------|------|-----|-----|------|------|------|
| 1920 | 39.8 | 2.7  | 28.8 | 44.9 | 12.7 | 182.8 | 31.0 | 1.0 | 2.2 | 3.40 | -11. | 2.40 |
| 1921 | 41.9 | -20  | 25.5 | 45.6 | 12.4 | 182.6 | 28.2 | 1.0 | 2.7 | 7.70 | -10. | 3.90 |
| 1922 | 45.0 | 1.9  | 29.3 | 50.1 | 16.9 | 184.5 | 32.2 | 1.0 | 2.9 | 3.90 | -9.0 | 3.20 |
| 1923 | 49.2 | 5.2  | 34.1 | 57.2 | 18.4 | 189.7 | 37.0 | 1.0 | 2.9 | 4.70 | -8.0 | 2.80 |
| 1924 | 50.6 | 3.0  | 33.9 | 57.1 | 19.4 | 192.7 | 37.0 | 1.0 | 3.1 | 3.80 | -7.0 | 3.50 |
| 1925 | 52.6 | 5.1  | 35.4 | 61.0 | 20.1 | 197.8 | 38.6 | 1.0 | 3.2 | 5.50 | -6.0 | 3.30 |
| 1926 | 55.1 | 5.6  | 37.4 | 64.0 | 19.6 | 203.4 | 40.7 | 1.0 | 3.3 | 7.00 | -5.0 | 3.30 |
| 1927 | 56.2 | 4.2  | 37.9 | 64.4 | 19.8 | 207.6 | 41.5 | 1.0 | 3.6 | 6.70 | -4.0 | 4.00 |
| 1928 | 57.3 | 3.0  | 39.2 | 64.5 | 21.1 | 210.6 | 42.9 | 1.0 | 3.7 | 4.20 | -3.0 | 4.20 |
| 1929 | 57.8 | 5.1  | 41.3 | 67.0 | 21.7 | 215.7 | 45.3 | 1.0 | 4.0 | 4.00 | -2.0 | 4.10 |
| 1930 | 55.0 | 1.0  | 37.9 | 61.2 | 15.6 | 216.7 | 42.1 | 1.0 | 4.2 | 7.70 | -1.0 | 5.20 |
| 1931 | 50.9 | -3.4 | 34.5 | 53.4 | 11.4 | 213.3 | 39.3 | 1.0 | 4.8 | 7.50 | .00  | 5.90 |
| 1932 | 45.6 | -6.2 | 29.0 | 44.3 | 7.00 | 207.1 | 34.3 | 1.0 | 5.3 | 8.30 | 1.0  | 4.90 |
| 1933 | 46.5 | -5.1 | 28.5 | 45.1 | 11.2 | 202.0 | 34.1 | 1.0 | 5.6 | 5.40 | 2.0  | 3.70 |
| 1934 | 48.7 | -3.0 | 30.6 | 49.7 | 12.3 | 199.0 | 36.6 | 1.0 | 6.0 | 6.80 | 3.0  | 4.00 |
| 1935 | 51.3 | -1.3 | 33.2 | 54.4 | 14.0 | 197.7 | 39.3 | 1.0 | 6.1 | 7.20 | 4.0  | 4.40 |
| 1936 | 57.7 | 2.1  | 36.8 | 62.7 | 17.6 | 199.8 | 44.2 | 1.0 | 7.4 | 8.30 | 5.0  | 2.90 |
| 1937 | 58.7 | 2.0  | 41.0 | 65.0 | 17.3 | 201.8 | 47.7 | 1.0 | 6.7 | 6.70 | 6.0  | 4.30 |
| 1938 | 57.5 | -1.9 | 38.2 | 60.9 | 15.3 | 199.9 | 45.9 | 1.0 | 7.7 | 7.40 | 7.0  | 5.30 |
| 1939 | 61.6 | 1.3  | 41.6 | 69.5 | 19.0 | 201.2 | 49.4 | 1.0 | 7.8 | 8.90 | 8.0  | 6.60 |
| 1940 | 65.0 | 3.3  | 45.0 | 75.7 | 21.1 | 204.5 | 53.0 | 1.0 | 8.0 | 9.60 | 9.0  | 7.40 |
| 1941 | 69.7 | 4.9  | 53.3 | 88.4 | 23.5 | 209.4 | 61.8 | 1.0 | 8.5 | 11.6 | 10.  | 13.8 |

OLS estimation of stochastic structural equations. Estimation (sample) period: 1921 - 1941. Annual data

| Consumption equation               |         |         |                 | Investment equation                |         |          |                 | Private wages equation             |         |         |                 |
|------------------------------------|---------|---------|-----------------|------------------------------------|---------|----------|-----------------|------------------------------------|---------|---------|-----------------|
| 'C' = 1., 'P', 'P-1', 'W'          |         |         |                 | 'I' = 1., 'P', 'P-1', 'K-1'        |         |          |                 | 'Wp' = 1., 'X', 'X-1', 'A'         |         |         |                 |
| Coeff.                             | Std.err | t-Stud. | Average variab. | Coeff.                             | Std.err | t-Stud.  | Average variab. | Coeff.                             | Std.err | t-Stud. | Average variab. |
| 16.2366                            | 1.30270 | 12.4638 | 1.00000         | 10.1258                            | 5.46555 | 1.85266  | 1.00000         | 1.49704                            | 1.27004 | 1.17875 | 1.00000         |
| .192934                            | .091210 | 2.11527 | 16.8905         | .479636                            | .097114 | 4.93886  | 16.8905         | .439477                            | .032408 | 13.5609 | 60.0571         |
| .089885                            | .090648 | .991588 | 16.3762         | .333039                            | .100859 | 3.30202  | 16.3762         | .146090                            | .037423 | 3.90371 | 57.9857         |
| .796219                            | .039944 | 19.9334 | 41.4810         | -.111795                           | .026728 | -4.18275 | 200.495         | .130245                            | .031910 | 4.08160 | .0              |
| Coeff. of determin. (R**2) .981008 |         |         |                 | Coeff. of determin. (R**2) .931348 |         |          |                 | Coeff. of determin. (R**2) .987414 |         |         |                 |
| Standard error of equation 1.02554 |         |         |                 | Standard error of equation 1.00945 |         |          |                 | Standard error of equation .767149 |         |         |                 |
| Durbin-Watson statistic 1.36747    |         |         |                 | Durbin-Watson statistic 1.81018    |         |          |                 | Durbin-Watson statistic 1.95843    |         |         |                 |

```

C *****
C * Fortran code (part) for solution with Jacobi method (YY and Y are "different" vectors) *
C * or with Gauss-Seidel method (YY and Y are "the same" vector, with two different names) *
C
C
C      List of endogenous variables
C Y(1)  = C      Consumption.
C Y(2)  = I      Investment.
C Y(3)  = Wp     Private wages.
C Y(4)  = X      Equilibrium demand (=National product + T)
C Y(5)  = P      Profits.
C Y(6)  = K      End-of-year Capital stock.
C Y(7)  = W      Total wages (=Wp+Wg)
C
C      List of exogenous variables
C Z(1,t) = 1.    Constant
C Z(2,t) = Wg    Government wages.
C Z(3,t) = T      Business taxes.
C Z(4,t) = A      Proxy for trade unions behav.=time trend (1931=0)
C Z(5,t) = G      Government nonwage spending.
C
C      List of equations
C      Consumption.
C      YY(1) = A(1)*Z(1,t)+A(2)*Y(5)+A(3)*Ylag(5,t-1)+A(4)*Y(7) + U(1)
C
C      Investment
C      YY(2) = A(5)*Z(1,t)+A(6)*Y(5)+A(7)*Ylag(5,t-1)+A(8)*Ylag(6,t-1) + U(2)
C
C      Private wages
C      YY(3) = A(9)*Z(1,t)+A(10)*Y(4)+A(11)*Ylag(4,t-1)+A(12)*Z(4,t) + U(3)
C
C      Equilibrium demand
C      YY(4) = Y(1)+Y(2)+Z(5,t)
C
C      Profits
C      YY(5) = Y(4)-Z(3,t)-Y(3)
C
C      Capital stock
C      YY(6) = Ylag(6,t-1)+Y(2)
C
C      Total wages
C      YY(7) = Y(3)+Z(2,t)
C *****

```

7 Endogenous variables - 3 Stochastic equations - 5 Exogenous variables  
 12 Estimated coefficients - 1920 1941 Time range - 1921 1941 Sample period

\*\*\*\*\*  
 \* One-Step-Ahead (Static) Solution - OLS structural coefficients \*  
 \*\*\*\*\*  
 Year 1921 Year 1922

| Variable | Observed | Computed | % Error     | Variable | Observed | Computed | % Error |
|----------|----------|----------|-------------|----------|----------|----------|---------|
| Y(1)=C   | 41.9000  | 43.9284  | 4.84101     | Y(1)=C   | 45.0000  | 48.1869  | 7.08189 |
| Y(2)=I   | -.200000 | -.211785 | 5.89235     | Y(2)=I   | 1.90000  | 3.33087  | 75.3092 |
| Y(3)=Wp  | 25.5000  | 27.6804  | 8.55070     | Y(3)=Wp  | 29.3000  | 31.0337  | 5.91713 |
| Y(4)=X   | 45.6000  | 47.6166  | 4.42236     | Y(4)=X   | 50.1000  | 54.7177  | 9.21702 |
| Y(5)=P   | 12.4000  | 12.2362  | -1.32121    | Y(5)=P   | 16.9000  | 19.7840  | 17.0651 |
| Y(6)=K   | 182.600  | 182.588  | -.645383e-2 | Y(6)=K   | 184.500  | 185.931  | .775542 |
| Y(7)=W   | 28.2000  | 30.3804  | 7.73202     | Y(7)=W   | 32.2000  | 33.9337  | 5.38422 |

.....other years .....

Output for Variable Y(1)=C for Years 1921 - 1941      Output for Variable Y(5)=P for Years 1921 - 1941

| Year | Observed Value | Comput. Value | % Error  | Observed %Change | Comput. %Change | Year | Observed Value | Comput. Value | % Error  | Observed %Change | Comput. %Change |
|------|----------------|---------------|----------|------------------|-----------------|------|----------------|---------------|----------|------------------|-----------------|
| 1921 | 41.9000        | 43.9284       | 4.84101  |                  |                 | 1921 | 12.4000        | 12.2362       | -1.32121 |                  |                 |
| 1922 | 45.0000        | 48.1869       | 7.08189  | 7.39857          | 9.69411         | 1922 | 16.9000        | 19.7840       | 17.0651  | 36.2903          | 61.6846         |
| 1923 | 49.2000        | 50.3380       | 2.31309  | 9.33333          | 4.46427         | 1923 | 18.4000        | 19.9412       | 8.37594  | 8.87574          | .794414         |
| 1924 | 50.6000        | 54.2978       | 7.30784  | 2.84553          | 7.86627         | 1924 | 19.4000        | 23.0849       | 18.9945  | 5.43478          | 15.7651         |
| 1925 | 52.6000        | 52.2601       | -.646148 | 3.95257          | -3.75271        | 1925 | 20.1000        | 18.8844       | -6.04758 | 3.60825          | -18.1958        |
| 1926 | 55.1000        | 50.6623       | -8.05385 | 4.75285          | -3.05739        | 1926 | 19.6000        | 14.3922       | -26.5704 | -2.48756         | -23.7880        |
| 1927 | 56.2000        | 51.8835       | -7.68067 | 1.99637          | 2.41034         | 1927 | 19.8000        | 14.8901       | -24.7972 | 1.02041          | 3.45980         |
| 1928 | 57.3000        | 55.2600       | -3.56019 | 1.95730          | 6.50794         | 1928 | 21.1000        | 20.4843       | -2.91787 | 6.56566          | 37.5697         |
| 1929 | 57.8000        | 56.5899       | -2.09352 | .872600          | 2.40669         | 1929 | 21.7000        | 21.5775       | -.564732 | 2.84360          | 5.33639         |
| 1930 | 55.0000        | 53.8983       | -2.00304 | -4.84429         | -4.75636        | 1930 | 15.6000        | 14.3352       | -8.10762 | -28.1106         | -33.5639        |
| 1931 | 50.9000        | 50.9713       | .140127  | -7.45455         | -5.43060        | 1931 | 11.4000        | 12.2391       | 7.36033  | -26.9231         | -14.6223        |
| 1932 | 45.6000        | 45.7654       | .362793  | -10.4126         | -10.2134        | 1932 | 7.00000        | 6.98673       | -.189582 | -38.5965         | -42.9146        |
| 1933 | 46.5000        | 44.8969       | -3.44754 | 1.97368          | -1.89781        | 1933 | 11.2000        | 10.4154       | -7.00577 | 60.0000          | 49.0734         |
| 1934 | 48.7000        | 48.9169       | .445435  | 4.73118          | 8.95392         | 1934 | 12.3000        | 12.9839       | 5.55996  | 9.82143          | 24.6609         |
| 1935 | 51.3000        | 51.3647       | .126210  | 5.33881          | 5.00403         | 1935 | 14.0000        | 14.0607       | .433760  | 13.8211          | 8.29376         |
| 1936 | 57.7000        | 52.4316       | -9.13068 | 12.4756          | 2.07701         | 1936 | 17.6000        | 11.6524       | -33.7931 | 25.7143          | -17.1280        |
| 1937 | 58.7000        | 58.9735       | .465976  | 1.73310          | 12.4771         | 1937 | 17.3000        | 18.8319       | 8.85474  | -1.70455         | 61.6135         |
| 1938 | 57.5000        | 61.6210       | 7.16703  | -2.04429         | 4.48932         | 1938 | 15.3000        | 19.7851       | 29.3142  | -11.5607         | 5.06162         |
| 1939 | 61.6000        | 60.4109       | -1.93033 | 7.13043          | -1.96382        | 1939 | 19.0000        | 18.0957       | -4.75950 | 24.1830          | -8.53863        |
| 1940 | 65.0000        | 65.0920       | .141601  | 5.51948          | 7.74881         | 1940 | 21.1000        | 20.2771       | -3.90017 | 11.0526          | 12.0546         |
| 1941 | 69.7000        | 76.1503       | 9.25439  | 7.23077          | 16.9887         | 1941 | 23.5000        | 29.7621       | 26.6471  | 11.3744          | 46.7770         |

.....other variables .....

|         | RMSE (dimensionless) | RMSE    | MAPE    | H.Theil: Inequality Coefficients Applied Economic Forecasting (1966), p.59 Eq.(4.5) | Eq.(4.6) |
|---------|----------------------|---------|---------|---|----------|
| Y(1)=C  | .515210e-1           | 2.80319 | 3.72349 | .964430   | 1.07951  |
| Y(2)=I  | .569947              | 2.10341 |         |   |          |
| Y(3)=Wp | .561012e-1           | 2.06894 | 4.31788 | .716739   | .791919  |
| Y(4)=X  | .787624e-1           | 4.80013 | 5.46199 | .997709   | 1.08002  |
| Y(5)=P  | .168088              | 2.92227 | 11.5514 | 1.08204   | 1.11706  |
| Y(6)=K  | .104148e-1           | 2.10341 | .730163 | .728021   | .785039  |
| Y(7)=W  | .491070e-1           | 2.06894 | 3.81188 | .705439   | .811302  |

Year 1921 Year 1922

.....other years .....

Output for Variable Y(5)=P for Years 1921 - 1941

.....other variables .....

## Impact and Delay (Interim) Multipliers computed from OLS structural coefficients

| Variable          | Year 1938                    |            | from Year 1938 to 1939 |            | from Year 1938 to 1940 |            | from Year 1938 to 1941 |             |
|-------------------|------------------------------|------------|------------------------|------------|------------------------|------------|------------------------|-------------|
|                   | Multiplier                   | Elasticity | Multiplier             | Elasticity | Multiplier             | Elasticity | Multiplier             | Elasticity  |
| Exogenous Z(2)=Wg | ..... Dynamic solution ..... |            |                        |            |                        |            |                        |             |
| Y(1)=C            | 2.13175                      | .266378    | 1.50454                | .180569    | .705218                | .833886e-1 | -.124064               | -.130379e-1 |
| Y(2)=I            | .783850                      | 2.14272    | .898356                | 2.03129    | .191302                | .558909    | -.349000               | -.473862    |
| Y(3)=Wp           | 1.28134                      | .231860    | 1.48196                | .251788    | .745038                | .123286    | -.769281e-1            | -.108615e-1 |
| Y(4)=X            | 2.91560                      | .321922    | 2.40289                | .249480    | .896520                | .918535e-1 | -.473064               | -.392769e-1 |
| Y(5)=P            | 1.63426                      | .636025    | .920937                | .355570    | .151481                | .613186e-1 | -.396136               | -.114650    |
| Y(6)=K            | .783850                      | .294973e-1 | 1.68221                | .622673e-1 | 1.87351                | .684808e-1 | 1.52451                | .542633e-1  |
| Y(7)=W            | 2.28134                      | .349559    | 1.48196                | .214816    | .745038                | .105200    | -.769281e-1            | -.939688e-2 |

|                  |                              |             |          |             |          |          |             |             |
|------------------|------------------------------|-------------|----------|-------------|----------|----------|-------------|-------------|
| Exogenous Z(3)=T | ..... Dynamic solution ..... |             |          |             |          |          |             |             |
| Y(1)=C           | -1.32106                     | -.158645    | -1.98022 | -.228400    | -1.15120 | -.130820 | .644746e-1  | .651168e-2  |
| Y(2)=I           | -1.14176                     | -2.99949    | -1.40183 | -3.04620    | -.409872 | -1.15083 | .451388     | .589003     |
| Y(3)=Wp          | -1.08235                     | -.188223    | -1.84613 | -.301441    | -1.18014 | -.187676 | -.134738e-2 | -.182825e-3 |
| Y(4)=X           | -2.46282                     | -.261334    | -3.38205 | -.337460    | -1.56107 | -.153709 | .515862     | .411616e-1  |
| Y(5)=P           | -2.38047                     | -.890341    | -1.53592 | -.569909    | -.380933 | -.148191 | .517210     | .143860     |
| Y(6)=K           | -1.14176                     | -.412918e-1 | -2.54359 | -.904833e-1 | -2.95346 | -.103749 | -2.50207    | -.855888e-1 |
| Y(7)=W           | -1.08235                     | -.159383    | -1.84613 | -.257179    | -1.18014 | -.160144 | -.134738e-2 | -.158172e-3 |

|                  |                              |            |         |            |         |            |             |             |
|------------------|------------------------------|------------|---------|------------|---------|------------|-------------|-------------|
| Exogenous Z(5)=G | ..... Dynamic solution ..... |            |         |            |         |            |             |             |
| Y(1)=C           | 1.67734                      | .144267    | 1.88960 | .156098    | .885708 | .720874e-1 | -.155816    | -.112710e-1 |
| Y(2)=I           | .984465                      | 1.85233    | 1.12828 | 1.75600    | .240263 | .483163    | -.438321    | -.409642    |
| Y(3)=Wp          | 1.60928                      | .200438    | 1.86124 | .217665    | .935720 | .106578    | -.966167e-1 | -.938948e-2 |
| Y(4)=X           | 3.66181                      | .278293    | 3.01788 | .215670    | 1.12597 | .794051e-1 | -.594138    | -.339539e-1 |
| Y(5)=P           | 2.05253                      | .549829    | 1.15664 | .307381    | .190251 | .530085e-1 | -.497521    | -.991123e-1 |
| Y(6)=K           | .984465                      | .254997e-1 | 2.11274 | .538286e-1 | 2.35301 | .592000e-1 | 1.91468     | .469093e-1  |
| Y(7)=W           | 1.60928                      | .169726    | 1.86124 | .185703    | .935720 | .909426e-1 | -.966167e-1 | -.812338e-2 |

|  |                       |          |
|--|-----------------------|----------|
| Dynamic reduced form matrix: diagonal coefficients | Modulus of Eigenvalue | Period   |
| Coeff.of Y(4,t-1) with respect to Y(4): .508269e-1 | Eig(1)= .627251       | 13.4246  |
| Coeff.of Y(5,t-1) with respect to Y(5): .615418    | Eig(2)= .627251       | -13.4246 |
| Coeff.of Y(6,t-1) with respect to Y(6): .746864    | Eig(3)= .293520       | .0       |

## Alternative Estimates of structural form coefficients

| OLS                        |          |         |          | 2SLS    |          |         |          | LIVE (2 iter. from OLS) |          |         |          |
|----------------------------|----------|---------|----------|---------|----------|---------|----------|-------------------------|----------|---------|----------|
| 1                          | P        | P-1     | W        | 1       | P        | P-1     | W        | 1                       | P        | P-1     | W        |
| 16.2366                    | .192934  | .089885 | .796219  | 16.5548 | .017302  | .216234 | .810183  | 16.8014                 | -.115631 | .312132 | .820507  |
| 1                          | P        | P-1     | K-1      | 1       | P        | P-1     | K-1      | 1                       | P        | P-1     | K-1      |
| 10.1258                    | .479636  | .333039 | -.111795 | 20.2782 | .150222  | .615944 | -.157788 | 21.6005                 | .107318  | .652790 | -.163778 |
| 1                          | X        | X-1     | A        | 1       | X        | X-1     | A        | 1                       | X        | X-1     | A        |
| 1.49704                    | .439477  | .146090 | .130245  | 1.50030 | .438859  | .146674 | .130396  | 1.60111                 | .419711  | .164768 | .135058  |
| I.I.V. (10 iter. from OLS) |          |         |          | 3SLS    |          |         |          | Iterative 3SLS          |          |         |          |
| 1                          | P        | P-1     | W        | 1       | P        | P-1     | W        | 1                       | P        | P-1     | W        |
| 16.7858                    | -.117503 | .312609 | .821456  | 16.4408 | .124890  | .163144 | .790081  | 16.5590                 | .164510  | .176564 | .765801  |
| 1                          | P        | P-1     | K-1      | 1       | P        | P-1     | K-1      | 1                       | P        | P-1     | K-1      |
| 21.6064                    | .107126  | .652955 | -.163805 | 28.1778 | -.013079 | .755724 | -.194848 | 42.8963                 | -.356532 | 1.01130 | -.260200 |
| 1                          | X        | X-1     | A        | 1       | X        | X-1     | A        | 1                       | X        | X-1     | A        |
| 1.59635                    | .420614  | .163914 | .134838  | 1.79722 | .400492  | .181291 | .149674  | 2.62477                 | .374779  | .193651 | .167926  |
| FIVE (2 iter. from OLS)    |          |         |          | FIML    |          |         |          |                         |          |         |          |
| 1                          | P        | P-1     | W        | 1       | P        | P-1     | W        |                         |          |         |          |
| 16.4570                    | .091267  | .198055 | .789598  | 18.3433 | -.232389 | .385673 | .801844  |                         |          |         |          |
| 1                          | P        | P-1     | K-1      | 1       | P        | P-1     | K-1      |                         |          |         |          |
| 24.7860                    | .029683  | .717039 | -.178374 | 27.2639 | -.801006 | 1.05185 | -.148099 |                         |          |         |          |
| 1                          | X        | X-1     | A        | 1       | X        | X-1     | A        |                         |          |         |          |
| 1.93827                    | .383522  | .196435 | .157667  | 5.79429 | .234118  | .284677 | .234835  |                         |          |         |          |

## Variance-covariance matrices estimated from structural form residuals (without degrees of freedom correction)

| OLS      |         |         | 2SLS           |         |         | LIVE (2 iter. from OLS) |         |         | I.I.V. (10 iter. from OLS) |         |         |
|----------|---------|---------|----------------|---------|---------|-------------------------|---------|---------|----------------------------|---------|---------|
| .851402  |         |         | 1.04406        |         |         | 1.44650                 |         |         | 1.45233                    |         |         |
| .049497  | .824891 |         | .437848        | 1.38318 |         | .726600                 | 1.53808 |         | .729292                    | 1.53882 |         |
| -.380815 | .121170 | .476417 | -.385228       | .192606 | .476427 | -.339635                | .273549 | .486842 | -.341982                   | .270234 | .485911 |
| 3SLS     |         |         | Iterative 3SLS |         |         | FIVE (2 iter. from OLS) |         |         | FIML                       |         |         |
| .891760  |         |         | .914909        |         |         | .937914                 |         |         | 2.10415                    |         |         |
| .411319  | 2.09305 |         | .641739        | 4.55536 |         | .442160                 | 1.86804 |         | 3.87902                    | 12.7715 |         |
| -.393615 | .403046 | .520027 | -.434985       | .734498 | .605649 | -.379888                | .452247 | .565780 | .481696                    | 3.85748 | 1.80112 |

Identification: Matrices of ‘‘Exclusion Restrictions’’ for the three stochastic equations

| Phi1(15,10)           | Phi2(15,10)           | Phi3(15,10)           |
|-----------------------|-----------------------|-----------------------|
| 0 0 0 0 0 0 0 0 0 0 0 | 1 0 0 0 0 0 0 0 0 0 0 | 1 0 0 0 0 0 0 0 0 0 0 |
| 1 0 0 0 0 0 0 0 0 0 0 | 0 0 0 0 0 0 0 0 0 0 0 | 0 1 0 0 0 0 0 0 0 0 0 |
| 0 1 0 0 0 0 0 0 0 0 0 | 0 1 0 0 0 0 0 0 0 0 0 | 0 0 0 0 0 0 0 0 0 0 0 |
| 0 0 1 0 0 0 0 0 0 0 0 | 0 0 1 0 0 0 0 0 0 0 0 | 0 0 0 0 0 0 0 0 0 0 0 |
| 0 0 0 0 0 0 0 0 0 0 0 | 0 0 0 0 0 0 0 0 0 0 0 | 0 0 1 0 0 0 0 0 0 0 0 |
| 0 0 0 1 0 0 0 0 0 0 0 | 0 0 0 1 0 0 0 0 0 0 0 | 0 0 0 1 0 0 0 0 0 0 0 |
| 0 0 0 0 0 0 0 0 0 0 0 | 0 0 0 0 1 0 0 0 0 0 0 | 0 0 0 0 1 0 0 0 0 0 0 |
| 0 0 0 0 0 0 0 0 0 0 0 | 0 0 0 0 0 0 0 0 0 0 0 | 0 0 0 0 0 0 0 0 0 0 0 |
| 0 0 0 0 1 0 0 0 0 0 0 | 0 0 0 0 0 1 0 0 0 0 0 | 0 0 0 0 0 1 0 0 0 0 0 |
| 0 0 0 0 0 1 0 0 0 0 0 | 0 0 0 0 0 0 1 0 0 0 0 | 0 0 0 0 0 0 1 0 0 0 0 |
| 0 0 0 0 0 0 1 0 0 0 0 | 0 0 0 0 0 0 0 1 0 0 0 | 0 0 0 0 0 0 0 1 0 0 0 |
| 0 0 0 0 0 0 0 1 0 0 0 | 0 0 0 0 0 0 0 0 1 0 0 | 0 0 0 0 0 0 0 0 1 0 0 |
| 0 0 0 0 0 0 0 0 1 0 0 | 0 0 0 0 0 0 0 0 0 1 0 | 0 0 0 0 0 0 0 0 0 1 0 |
| 0 0 0 0 0 0 0 0 0 1 0 | 0 0 0 0 0 0 0 0 0 0 1 | 0 0 0 0 0 0 0 0 0 0 1 |
| 0 0 0 0 0 0 0 0 0 0 1 | 0 0 0 0 0 0 0 0 0 0 0 | 0 0 0 0 0 0 0 0 0 0 1 |

A non-linear version of the Klein-I model (Belsley, 1980): the first structural equation (consumption) is replaced by

$$\ln C_t = \alpha_1 + \alpha_2 \ln P_t + \alpha_3 \ln P_{t-1} + \alpha_4 \ln W_t + u_{1,t} \quad \text{Consumption} \quad (15.68)$$

while all the other equations are the same as (2.1).

#### Alternative Estimates of structural form coefficients

| OLS     |         |         |          | I.I.V. (9 iter. from OLS) |         |         |          | NL-FIML |          |         |          |
|---------|---------|---------|----------|---------------------------|---------|---------|----------|---------|----------|---------|----------|
| 1       | P       | P-1     | W        | 1                         | P       | P-1     | W        | 1       | P        | P-1     | W        |
| 1.42867 | .054133 | .017128 | .634552  | 1.43554                   | .002594 | .051195 | .646111  | 1.42365 | .048579  | .031093 | .629689  |
| 1       | P       | P-1     | K-1      | 1                         | P       | P-1     | K-1      | 1       | P        | P-1     | K-1      |
| 10.1258 | .479636 | .333039 | -.111795 | 22.2134                   | .087431 | .669869 | -.166555 | 33.0054 | -.248046 | .884421 | -.209644 |
| 1       | X       | X-1     | A        | 1                         | X       | X-1     | A        | 1       | X        | X-1     | A        |
| 1.49704 | .439477 | .146090 | .130245  | 1.58788                   | .422223 | .162394 | .134446  | 2.85672 | .331213  | .234773 | .163017  |

\*\*\*\*\*  
\* One-Step-Ahead (Static) Solution - OLS structural coefficients \*  
\*\*\*\*\*

|          | RMSE<br>(dimensionless) | RMSE    | MAPE    | H.Theil: Inequality Coefficients<br>Eq.(4.5) | H.Theil: Inequality Coefficients<br>Eq.(4.6) |
|----------|-------------------------|---------|---------|--|--|
| Y(1)=C   | .466356e-1              | 2.53716 | 3.67048 | .937936                                      | 1.04986                                      |
| Y(2)=I   | .559567                 | 2.06510 |         |  |  |
| Y(3)=Wp  | .532651e-1              | 1.96435 | 4.34570 | .710552                                      | .785083                                      |
| Y(4)=X   | .742997e-1              | 4.52815 | 5.56905 | .993299                                      | 1.07525                                      |
| Y(5)=P   | .159150                 | 2.76688 | 12.9225 | 1.10505                                      | 1.14081                                      |
| Y(6)=K   | .102252e-1              | 2.06510 | .771039 | .722178                                      | .778739                                      |
| Y(7)=W   | .466245e-1              | 1.96435 | 3.82079 | .700030                                      | .805081                                      |
| Y(8)=lnC | .115287e-1              | .045921 | .925162 | .911714                                      | 1.00951                                      |

\*\*\*\*\*  
\* Dynamic Solution - OLS structural coefficients \*  
\*\*\*\*\*

|          | RMSE<br>(dimensionless) | RMSE    | MAPE    | H.Theil: Inequality Coefficients<br>Eq.(4.5) | H.Theil: Inequality Coefficients<br>Eq.(4.6) |
|----------|-------------------------|---------|---------|--|--|
| Y(1)=C   | .978162e-1              | 5.32206 | 8.24905 | 1.32330                                      | 1.48121                                      |
| Y(2)=I   | .976774                 | 3.60481 |         |  |  |
| Y(3)=Wp  | .131097                 | 4.83458 | 11.1280 | 1.14688                                      | 1.26718                                      |
| Y(4)=X   | .143958                 | 8.77346 | 12.6106 | 1.29005                                      | 1.39649                                      |
| Y(5)=P   | .250216                 | 4.35009 | 24.0321 | 1.29237                                      | 1.33419                                      |
| Y(6)=K   | .314611e-1              | 6.35397 | 2.35760 | .964979                                      | 1.04057                                      |
| Y(7)=W   | .114750                 | 4.83458 | 9.77070 | 1.14692                                      | 1.31904                                      |
| Y(8)=lnC | .258048e-1              | .102785 | 2.09962 | 1.33017                                      | 1.47285                                      |

1. Transformation of univariate random variables: if the random variable  $x$ , with probability density function  $f(x)$ , is transformed into the random variable  $y = y(x)$ , if the transformation is continuously differentiable and invertible [ $x = x(y)$ ], then the p.d.f. of  $y$  is  $g(y) = f[x(y)] |dx(y)/dy|$ .
2. Transformation of multivariate random variables: if the  $(k \times 1)$  random vector  $x$ , with joint p.d.f.  $f(x)$ , is transformed into the  $(k \times 1)$  random vector  $y = y(x)$ , if the transformation is continuously differentiable and invertible [ $x = x(y)$ ] with non-singular square Jacobian matrix  $\partial x(y)/\partial y'$ , then the joint p.d.f. of  $y$  is  $g(y) = f[x(y)] \|\partial x(y)/\partial y'\|$  (where  $\|\cdots\|$  means absolute value of determinant).
3. Let  $\mu$  be a  $(k \times 1)$  constant vector and  $\Sigma$  a symmetric  $(k \times k)$  positive definite constant matrix, that can be decomposed as  $\Sigma = P'P$ , with  $P$  a non-singular  $(k \times k)$  constant matrix. The determinant of  $P$  is the square root of the determinant of  $\Sigma$ :  $|P| = |\Sigma|^{1/2}$ . Let  $z$  be a  $(k \times 1)$  random vector whose expectation is zero and the variance-covariance matrix is the identity matrix:  $E(z) = 0$ ,  $V(z) = I_k$ . Whatever the probability distribution of  $z$ , the  $(k \times 1)$  random vector  $x = P'z + \mu$  has expectation  $\mu$  and variance-covariance matrix  $\Sigma = P'P$ . Being  $P$  non-singular, the transformation from  $z$  to  $x$  is continuously differentiable and invertible [ $z = P'^{-1}(x - \mu)$ ] with non-singular square Jacobian matrix  $\partial z(x)/\partial x' = P'^{-1}$ .
4. If the elements of the  $(k \times 1)$  random vector  $z$  are independent standard normal variables [ $z_i$  are *i.i.d.*  $N(0, 1)$ ], we say that the vector  $z$  has a multivariate normal distribution:  $z \sim N(0, I_k)$ . The joint p.d.f. of the elements of  $z$  is the product of the univariate density functions:  $f(z) = \prod_{i=1}^k \frac{1}{(2\pi)^{1/2}} \exp\left[-\frac{z_i^2}{2}\right] = \frac{1}{(2\pi)^{k/2}} \exp\left[-\frac{1}{2} \sum_{i=1}^k z_i^2\right]$ . It is positive everywhere, and its integral is 1, being the product of  $k$  integrals, each = 1. With vector notation, the same p.d.f. can be written  $f(z) = \frac{1}{(2\pi)^{k/2}} \exp\left[-\frac{1}{2} z'z\right]$ .
5. Using the result on the transformation of random vectors (2), the  $(k \times 1)$  random vector  $x = P'z + \mu$  has p.d.f.  $f(x) = \frac{1}{(2\pi)^{k/2} |P|} \exp\left[-\frac{1}{2} (x - \mu)' P'^{-1} P^{-1} (x - \mu)\right] = \frac{1}{(2\pi)^{k/2} |\Sigma|^{1/2}} \exp\left[-\frac{1}{2} (x - \mu)' \Sigma^{-1} (x - \mu)\right]$ . We say that the  $(k \times 1)$  random vector  $x$  has a multivariate normal distribution  $N(\mu, \Sigma)$ . Using the result in (3),  $\mu$  is the expectation and  $\Sigma$  is the variance-covariance matrix of  $x$ .

*Warning.* This definition requires  $\Sigma$  to be positive definite. It is possible to define multivariate normal distributions also when  $\Sigma$  is positive semi definite and singular, but these distributions do not admit an explicit p.d.f.

6. If  $x \sim N(\mu, \Sigma)$  and  $\Sigma$  is block-diagonal, the corresponding sub-vectors of  $x$  are independent multivariate normal vectors. Thus, uncorrelated sub-vectors are independent; moreover, each sub-vector has a marginal distribution multivariate normal. The proof follows considering that  $\Sigma^{-1}$  is also block-diagonal, and  $|\Sigma|$  is obtained multiplying the determinants of the diagonal blocks. Thus, the joint p.d.f.  $f(x)$  is the product of functions that are exactly the marginal densities of the sub-vectors. In particular, if  $\Sigma$  is diagonal, all the elements of  $x$  are independent normal variables.

*Warning.* The above properties depend on the *joint* density of the elements of  $x$  being normal. If it is only known that the *marginal* densities of the elements are normal, then the joint density needs not be normal and may even not exist. Thus, uncorrelated normal variables need not be independent if they are not *jointly* multivariate normal.

7. If the  $(k \times 1)$  random vector  $x \sim N(\mu, \Sigma)$  and  $A$  is a  $(k \times k)$  non-singular constant matrix, the  $(k \times 1)$  random vector  $y = Ax$  has a multivariate normal distribution  $y \sim N(A\mu, A\Sigma A')$ . The proof is simply based on the explicit p.d.f. expression of the transformed vector  $y$ , considering that  $A$  is the Jacobian matrix of the linear transformation.
8. Particular case: decomposing the positive definite matrix  $\Sigma = P'P$ , with  $P$  square and non-singular, the linear transformation  $z = P'^{-1}(x - \mu) \sim N(0, I_k)$  (vector of independent standard normal variables).
9. If the  $(k \times 1)$  random vector  $x \sim N(\mu, \Sigma)$ , any sub-vector of  $x$  has a marginal distribution multivariate normal, with means, variances and covariances obtained by taking the corresponding elements of  $\mu$  and  $\Sigma$ . To prove it, let  $x$  be *arbitrarily* decomposed into two sub-vectors  $x_1$  and  $x_2$ ; let  $\mu$  be correspondingly decomposed into  $\mu_1$  and  $\mu_2$ ; let  $\Sigma$  be correspondingly decomposed into  $\Sigma_{1,1}$ ,  $\Sigma_{1,2}$ ,  $\Sigma_{2,1} = \Sigma'_{1,2}$ ,  $\Sigma_{2,2}$  (where  $\Sigma_{1,1}$  and  $\Sigma_{2,2}$  are square blocks), and  $A$  a  $(k \times k)$  matrix, correspondingly decomposed into blocks  $A_{1,1} = I$ ,  $A_{1,2} = -\Sigma_{1,2}\Sigma_{2,2}^{-1}$ ,  $A_{2,1} = 0$ ,  $A_{2,2} = I$ . Thus,  $A\mu$  has two sub-vectors  $\mu_1 - \Sigma_{1,2}\Sigma_{2,2}^{-1}\mu_2$  and  $\mu_2$ , while  $A\Sigma A'$  is block-diagonal, the two square diagonal blocks being  $\Sigma_{1,1} - \Sigma_{1,2}\Sigma_{2,2}^{-1}\Sigma_{2,1}$  and  $\Sigma_{2,2}$ . The linear transformation  $y = Ax$  produces the multivariate normal vector  $y \sim N(A\mu, A\Sigma A')$  whose variance-covariance matrix is block-diagonal. Thus the two sub-vectors:  $y_1$  and  $y_2$  are independent multivariate normal vectors:  $y_1 \sim N[\mu_1 - \Sigma_{1,2}\Sigma_{2,2}^{-1}\mu_2, \Sigma_{1,1} - \Sigma_{1,2}\Sigma_{2,2}^{-1}\Sigma_{2,1}]$  and  $y_2 \sim N[\mu_2, \Sigma_{2,2}]$ . But  $x_2 = y_2$ ; thus the *arbitrary* sub-vector  $x_2$  has the multivariate normal distribution  $N(\mu_2, \Sigma_{2,2})$ .
10. Particular case: any element of a multivariate normal vector has univariate normal distribution, whose mean and variance are, respectively, the corresponding element of  $\mu$  and the corresponding diagonal element of  $\Sigma$ .
11. If the  $(k \times 1)$  random vector  $x \sim N(\mu, \Sigma)$  and  $D$  is a  $(p \times k)$  constant matrix of rank  $p \leq k$ , then the  $(p \times 1)$  vector  $y = Dx \sim N(D\mu, D\Sigma D')$ . To prove it, one should add  $k - p$  rows to the matrix  $D$ , producing a full-rank  $(k \times k)$  matrix. Multiplying such a matrix by  $x$  produces a multivariate normal vector, whose first sub-vector is  $Dx$ .

*Warning.* The result (11) is a particular case of a more general result, that holds also when  $p > k$  or when the rank of  $D$  is  $< p$ , and that we state without proof. *Any linear transformation of a multivariate normal is a multivariate normal.* This property, however, requires to deal also with multivariate normal distributions that do not admit an explicit p.d.f., due to singularity of the variance-covariance matrix (e.g. Rao, 1973, 8a).

12. The conditional distribution of  $x_1|x_2$  is multivariate normal  $x_1|x_2 \sim N[\mu_1 + \Sigma_{1,2}\Sigma_{2,2}^{-1}(x_2 - \mu_2), \Sigma_{1,1} - \Sigma_{1,2}\Sigma_{2,2}^{-1}\Sigma_{2,1}]$ . From (9) it follows that, being the Jacobian of the linear transformation  $|A| = 1$ , the expression of the p.d.f. of  $x$  is equal to the expression of the p.d.f. of  $y$ , when  $y$  in the expression is replaced with  $Ax$ . Thus  $f(x) = g(y)$ , thus  $f(x_2)f(x_1|x_2) = g(y_2)g(y_1|y_2) = g(y_2)g(y_1) = f(x_2)g(y_1)$ , being  $x_2 = y_2$  and being  $y_1$  and  $y_2$  independent. Thus  $f(x_1|x_2) = g(y_1)$ , when  $y_1$  in the expression of  $g$  is replaced with the first sub-vector of  $Ax$ . Writing explicitly the expression of the p.d.f. of  $y_1 \sim N[\mu_1 - \Sigma_{1,2}\Sigma_{2,2}^{-1}\mu_2, \Sigma_{1,1} - \Sigma_{1,2}\Sigma_{2,2}^{-1}\Sigma_{2,1}]$ , and replacing in the expression of the p.d.f.  $y_1$  with  $x_1 - \Sigma_{1,2}\Sigma_{2,2}^{-1}x_2$  (first sub-vector of  $Ax$ ), produces the explicit expression of the p.d.f. of a multivariate normal with mean  $\mu_1 + \Sigma_{1,2}\Sigma_{2,2}^{-1}(x_2 - \mu_2)$  and variance-covariance matrix  $\Sigma_{1,1} - \Sigma_{1,2}\Sigma_{2,2}^{-1}\Sigma_{2,1}$ .

*Remark.* The conditional mean of  $x_1|x_2$  is a linear function of  $x_2$ ; the conditional variance is independent of  $x_2$ .

## 17 APPENDIX. Some useful asymptotic results

1. If  $\text{plim } \hat{\theta}_n = \theta_0$  and  $g$  is a continuous function, then  $\text{plim } g(\hat{\theta}_n) = g(\theta_0)$ . This result extends to continuous functions a result proved by Slutsky (1925) for rational functions (e.g. Rao, 1973, 2c.4.xiii). It holds either in univariate or in multivariate cases.
2.  *$\delta$ -method* (univariate case e.g. Rao, 1973, 6a.2.i): if  $\sqrt{n}(\hat{\theta}_n - \theta_0)$  is asymptotically  $\sim N[0, \sigma^2]$ , and  $g$  is a continuously differentiable function with nonzero first derivative in  $\theta_0$ , then  $\sqrt{n}[g(\hat{\theta}_n) - g(\theta_0)]$  is asymptotically  $\sim N[0, g'(\theta_0)\sigma^2]$ . The proof follows from a first order Taylor expansion of  $g(\hat{\theta}_n)$  with origin  $\theta_0$ , recalling that the residual is  $o_p(\hat{\theta}_n - \theta_0)$ .
3.  *$\delta$ -method* (multivariate case e.g. Rao, 1973, 6a.2.iii): if the vector  $\sqrt{n}(\hat{\theta}_n - \theta_0)$  is asymptotically multivariate normal  $\sim N[0, \Sigma]$ , and  $g$  is a vector of continuously differentiable functions whose first derivatives are not all  $= 0$  in  $\theta_0$ , then  $\sqrt{n}[g(\hat{\theta}_n) - g(\theta_0)]$  has an asymptotic multivariate normal distribution  $\sim N[0, G\Sigma G']$ , where  $G$  is the Jacobian matrix  $\partial g/\partial \theta'$  computed in  $\theta_0$ .

## 18 APPENDIX. Probability density, score, information, likelihood

Let  $x_i$  be a random variable or vector (r.v.), whose probability density function (continuous) is characterized by a parameter (vector)  $\theta$ :  $f(x_i, \theta)$ . For any  $\theta$ ,  $f$  is a function whose integral is  $\equiv 1$ .

$$\int_{-\infty}^{+\infty} f(x_i, \theta) dx_i \equiv 1 \quad \forall \theta \quad (18.69)$$

Thus, differentiating (18.69) w.r.t.  $\theta$  we get

$$\frac{\partial}{\partial \theta} \left[ \int_{-\infty}^{+\infty} f(x_i, \theta) dx_i \right] \equiv 0 \quad \forall \theta \quad (18.70)$$

We assume that  $f$  satisfies some *regularity conditions* that permit differentiation under integral (for instance, it is twice differentiable w.r.t.  $\theta$  and the limits of integration are not functions of  $\theta$ ). So, (18.70) can be written

$$\int_{-\infty}^{+\infty} \frac{\partial f(x_i, \theta)}{\partial \theta} dx_i \equiv 0 \quad \forall \theta \quad (18.71)$$

Integration will be confined to the region where  $f$  assumes nonzero (positive) values. Thus (18.71) can be written

$$\int \frac{\partial \ln f(x_i, \theta)}{\partial \theta} f(x_i, \theta) dx_i \equiv 0 \quad \forall \theta \quad (18.72)$$

*Remark.* The proofs of this chapter are based on a *double interpretation* of the function  $f(x_i, \theta)$ . It must be considered a *probability density function*, but at the same time, being a *transformation* of the r.v.  $x_i$ , it is a random variable itself, with expectation and variance. The same *double interpretation* holds for the logarithm of  $f(x_i, \theta)$ , as well as its derivatives.

The derivative (vector of derivatives)  $\partial \ln f(x_i, \theta) / \partial \theta$  (*gradient* of the log-density) is usually called the *score*. If derivative (vector) is computed at the *true* parameter value, so that  $f(x_i, \theta)$  is the probability density of the r.v.  $x_i$ , equation (18.72) is the expectation of the r.v. *score*

$$E \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right] = \int \frac{\partial \ln f(x_i, \theta)}{\partial \theta} f(x_i, \theta) dx_i = 0 \quad (18.73)$$

Thus the expectation of the score is zero. The variance-covariance matrix of the score,  $\mathfrak{I}(\theta)$ , is called *information matrix* (more precisely, Fisher's information measure on  $\theta$  contained in the r.v.  $x_i$ )

$$\mathfrak{I}(\theta) = \text{Var} \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right] = E \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \frac{\partial \ln f(x_i, \theta)}{\partial \theta'} \right] \quad (18.74)$$

Further differentiation of (18.72) gives

$$\int \left[ \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} f(x_i, \theta) + \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \frac{\partial f(x_i, \theta)}{\partial \theta'} \right] dx_i \equiv 0 \quad \forall \theta$$

that is

$$\int \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} f(x_i, \theta) dx_i + \int \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \frac{\partial \ln f(x_i, \theta)}{\partial \theta'} f(x_i, \theta) dx_i \equiv 0 \quad \forall \theta \quad (18.75)$$

Again, if derivatives are computed at the *true* parameter value, so that  $f(x_i, \theta)$  is the probability density of the r.v.  $x_i$ , the two terms in equation (18.75) are expectations, so

$$E \left[ \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} \right] + E \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \frac{\partial \ln f(x_i, \theta)}{\partial \theta'} \right] \equiv 0 \quad \forall \theta \quad (18.76)$$

The second term of the sum is the information matrix (18.74). Thus, from (18.76) we get an alternative expression for the information matrix

$$\mathfrak{I}(\theta) = E \left[ - \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} \right] \quad (18.77)$$

that is the expected Hessian of the log-density, with the opposite sign.

If  $x_1, x_2, \dots, x_n$  are independent draws from the same distribution (random sample), the joint density of the sample is  $f(x_1, x_2, \dots, x_n, \theta) = f(x_1, \theta) f(x_2, \theta) \dots f(x_n, \theta)$ ; to simplify notations, it will simply be indicated as  $f(x, \theta)$ . The log-density of the sample will be therefore the sum of the log-densities, while its first and second derivatives as well as their expectations will be sums of the corresponding derivatives or expectations. As a straightforward consequence, the expectation of the score of the sample will be zero, while the information in the whole sample will be  $n\mathfrak{I}(\theta)$

$$E \left[ \frac{\partial \ln f(x, \theta)}{\partial \theta} \right] = 0$$



$$n\mathfrak{S}(\theta) = \text{Var} \left[ \frac{\partial \ln f(x, \theta)}{\partial \theta} \right] = E \left[ \frac{\partial \ln f(x, \theta)}{\partial \theta} \frac{\partial \ln f(x, \theta)}{\partial \theta'} \right] = E \left[ -\frac{\partial^2 \ln f(x, \theta)}{\partial \theta \partial \theta'} \right] \quad (18.78)$$

*Remark.* If  $f(x_i, \theta)$  (and therefore  $f(x, \theta)$ ) is a family of strictly positive functions whose integral is identically = 1 for any  $\theta$ , but for *no value* of  $\theta$  it is the probability density function of the r.v.  $x_i$ , all the above identities involving integrals (eqs. 18.69 - 18.72 and 18.76) are still valid, but they *cannot* be interpreted as *expected values*. This remark will be important when dealing with *quasi*-likelihood (or *pseudo*-likelihood).

### 18.1 Cramér-Rao inequality

Let  $\theta$  be a single parameter,  $x_1, x_2, \dots, x_n$  independent draws (random sample; each  $x_i$  can be a single variable or a vector), and let  $f(x, \theta)$  indicate the joint probability density of the whole sample. Let  $t(x)$  be an estimator of the parameter  $\theta$  (of course,  $t$  will be a function of the sample, and *not* of the parameter itself). Its expectation

$$E[t(x)] = \int t(x) f(x, \theta) dx \quad (18.79)$$

of course, will be a function of the parameter  $\theta$  and *not* of the sample.

Under the usual regularity conditions, differentiating (18.79) we get

$$\frac{\partial E[t(x)]}{\partial \theta} = \int t(x) \frac{\partial f(x, \theta)}{\partial \theta} dx = \int t(x) \frac{\partial \ln f(x, \theta)}{\partial \theta} f(x, \theta) dx = E \left[ t(x) \frac{\partial \ln f(x, \theta)}{\partial \theta} \right] = \text{Cov} \left[ t(x), \frac{\partial \ln f(x, \theta)}{\partial \theta} \right] \quad (18.80)$$

Since the squared covariance cannot exceed the product of the two variances, we have

$$\left[ \frac{\partial E[t(x)]}{\partial \theta} \right]^2 \leq \text{Var}[t(x)] \text{Var} \left[ \frac{\partial \ln f(x, \theta)}{\partial \theta} \right] = \text{Var}[t(x)] [n\mathfrak{S}(\theta)] \quad (18.81)$$

If the expected value of the estimator is a *regular* function of  $\theta$

$$E[t(x)] = h(\theta) \quad \text{so that} \quad \frac{\partial E[t(x)]}{\partial \theta} = \frac{\partial h(\theta)}{\partial \theta}$$

the Cramér-Rao inequality follows from (18.81)

$$\text{Var}[t(x)] \geq \left[ \frac{\partial h(\theta)}{\partial \theta} \right]^2 [n\mathfrak{S}(\theta)]^{-1} \quad (18.82)$$

In the particular case of an *unbiased* estimator,  $E[t(x)] = h(\theta) = \theta$ ; thus  $\partial h(\theta)/\partial \theta = 1$ , thus the Cramér-Rao inequality becomes

$$\text{Var}[t(x)] \geq [n\mathfrak{S}(\theta)]^{-1} \quad (18.83)$$

An unbiased estimator is *efficient* if its variance is the lower bound of the inequality:  $[n\mathfrak{S}(\theta)]^{-1}$ .

#### 18.1.1 Multidimensional Cramér-Rao inequality

When  $\theta$  is a  $(k \times 1)$  vector of parameters, analogously to (18.80) we have

$$\frac{\partial E[t(x)]}{\partial \theta'} = E \left[ t(x) \frac{\partial \ln f(x, \theta)}{\partial \theta'} \right] = \text{Cov} \left[ t(x), \frac{\partial \ln f(x, \theta)}{\partial \theta'} \right]$$

thus we can write as follows the variance-covariance matrix of the  $(2k \times 1)$  vector

$$\text{Var} \begin{bmatrix} t(x) \\ \frac{\partial \ln f(x, \theta)}{\partial \theta} \end{bmatrix} = \begin{bmatrix} \text{Var}[t(x)] & \text{Cov} \left[ t(x), \frac{\partial \ln f(x, \theta)}{\partial \theta'} \right] \\ \text{Cov} \left[ t(x)', \frac{\partial \ln f(x, \theta)}{\partial \theta} \right] & n\mathfrak{S}(\theta) \end{bmatrix} = \begin{bmatrix} \text{Var}[t(x)] & \frac{\partial E[t(x)]}{\partial \theta'} \\ \frac{\partial E[t(x)']}{\partial \theta} & n\mathfrak{S}(\theta) \end{bmatrix} \quad (18.84)$$

which is positive semi definite, being a variance-covariance matrix  $(2k \times 2k)$ . Thus, pre- and post-multiplication by a matrix and its transpose still provides a positive semi definite matrix. In particular, if the information matrix is not singular (i.e. the derivatives of the log-density are not linearly dependent), pre-multiplication by the  $(k \times 2k)$  matrix  $\left[ I_k ; -\frac{\partial E[t(x)]}{\partial \theta'} [n\mathfrak{S}(\theta)]^{-1} \right]$  and post-multiplication by its transpose produces

$$\left[ I_k ; -\frac{\partial E[t(x)]}{\partial \theta'} [n\mathfrak{S}(\theta)]^{-1} \right] \begin{bmatrix} \text{Var}[t(x)] & \frac{\partial E[t(x)]}{\partial \theta'} \\ \frac{\partial E[t(x)']}{\partial \theta} & n\mathfrak{S}(\theta) \end{bmatrix} \begin{bmatrix} I_k \\ -[n\mathfrak{S}(\theta)]^{-1} \frac{\partial E[t(x)']}{\partial \theta} \end{bmatrix} = \text{Var}[t(x)] - \left[ \frac{\partial E[t(x)]}{\partial \theta'} \right] [n\mathfrak{S}(\theta)]^{-1} \left[ \frac{\partial E[t(x)']}{\partial \theta} \right]$$

which is a positive semi definite matrix, implying the Cramér-Rao inequality

$$\text{Var}[t(x)] \geq \left[ \frac{\partial E[t(x)]}{\partial \theta'} \right] [n\mathfrak{S}(\theta)]^{-1} \left[ \frac{\partial E[t(x)']}{\partial \theta} \right] \quad (18.85)$$

where  $\text{Var}$  must be interpreted as the variance-covariance matrix of the estimator  $t(x)$ . The inequality is valid if the estimator is biased, but its expected value is a regular function of  $\theta$  (analogously to eq.18.82).

For unbiased estimators, where  $E[t(x)] = \theta$ , the inequality still has the form of equation (18.83),

## 18.2 Maximum Likelihood estimator: consistency (simplified proof)

When the sample  $x_1, x_2, \dots, x_n$  is observed, the function of  $\theta$  defined by  $L(x, \theta) = f(x, \theta)$  is called the *likelihood* of  $\theta$  given the observations.

*Remark.* Textbooks in probability and statistics often adopt two different notations:  $f(x|\theta) = f(x_1, \theta)f(x_2, \theta)\dots f(x_n, \theta)$  when considering the probability density function, to put into evidence that the r.v. is  $x$ , while  $\theta$  is a given parameter (vector);  $L(\theta|x)$  when considering the likelihood, thus evidencing a function of  $\theta$ , while  $x$  is a realized value of a set of observations. Of course they clearly specify that  $L(\theta|x) = f(x|\theta)$ . These different notations are unnecessary for the purposes of this chapter, which thus adopts standard *mathematical notations* ( $f(x, \theta)$  or  $L(x, \theta)$ ) to indicate functions of  $x$  and  $\theta$ .

Under suitable regularity conditions, maximum likelihood yields an estimator which is consistent, asymptotically normal with mean equal to the *true* parameter value and variance-covariance matrix equal to the inverse of the information matrix.

To simplify the proof, we consider  $\theta$  a single parameter. The sample  $x_1, x_2, \dots, x_n, \dots$  is made of independent draws from the same population; the density of each  $x_i$  belongs to the *family* of density functions  $f(x_i, \theta)$  for a particular value  $\theta = \theta_0$ ;  $\theta_0$  can be called the *true* parameter value.

Regularity conditions are requested to ensure that

1. differentiation can be done under integral for any  $\theta$  belonging to an interval (or a compact set) that contains the *true*  $\theta_0$  as an interior point;
2. the score, evaluated at  $\theta_0$ , has positive finite variance  $\Im(\theta_0)$ ;
3. the residual of a first order Taylor expansion of the score is bounded by a function of  $x_i$  with finite expectation (for instance, this condition could be satisfied assuming boundedness of the third derivative of the log-likelihood).

Applying first order Taylor expansion to the score, with initial point  $\theta_0$  we get

$$\frac{\partial \ln f(x_i, \theta)}{\partial \theta} = \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta_0} + \left[ \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta^2} \right]_{\theta_0} (\theta - \theta_0) + Res(x_i, \theta, \theta_0)$$

Summing for  $i = 1, 2, \dots, n$  and dividing by  $n$  (averaging) we get

$$\frac{1}{n} \frac{\partial \ln L(x, \theta)}{\partial \theta} = \frac{1}{n} \sum_{i=1}^n \frac{\partial \ln f(x_i, \theta)}{\partial \theta} = \frac{1}{n} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta_0} + \frac{1}{n} \sum_{i=1}^n \left[ \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta^2} \right]_{\theta_0} (\theta - \theta_0) + \frac{1}{n} \sum_{i=1}^n Res(x_i, \theta, \theta_0) \quad (18.86)$$

Some *suitable* form of the weak law of large numbers (WLLN) ensures that

$$plim \frac{1}{n} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta_0} = 0 \quad \text{and} \quad plim \frac{1}{n} \sum_{i=1}^n \left[ \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta^2} \right]_{\theta_0} = -\Im(\theta_0) \quad (18.87)$$

thus, for a conveniently large  $n$ , the first term on the right hand side of (18.86) will be negligible, while the second term will be negative if  $(\theta - \theta_0)$  is positive, and will be positive if  $(\theta - \theta_0)$  is negative. Concerning the residual term, for *large*  $n$  and *small*  $(\theta - \theta_0)$ , regularity conditions and Taylor expansion properties ensure that its contribution is negligible with respect to the other terms. The consequence is that, when  $n$  is large enough, analysing an arbitrarily small interval around  $\theta_0$ , the left hand side of (18.86) is positive on the left of  $\theta_0$ , negative on the right: thus, arbitrarily close to  $\theta_0$  there is a point where the log-likelihood has a *local* maximum (and the score is zero). This value will be indicated with  $\hat{\theta}$ . It is called the *maximum likelihood estimator* of  $\theta$ .

*Remark.* The (simplified) proof given above ensures the existence of a consistent root of the likelihood equation; it does not enable us to identify it (for instance, in case of multiple roots). It can be shown that the consistent root corresponds to the supremum of the likelihood with probability 1 (see Rao, 1973, 5f.2, who refers to papers by Wald, 1949, Le Cam, 1953, 1956, and Bahadur, 1958).

## 18.3 Maximum Likelihood estimator: asymptotic normality

Considering again  $\theta$  a vector of parameters, if (18.86) is computed at  $\hat{\theta}$ , the left hand side is zero. Multiplying by  $\sqrt{n}$  we get

$$\sqrt{n}(\hat{\theta} - \theta_0) = \left[ -\frac{1}{n} \sum_{i=1}^n \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} \right]_{\theta_0}^{-1} \left\{ \frac{1}{\sqrt{n}} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta_0} + \frac{1}{\sqrt{n}} \sum_{i=1}^n Res(x_i, \hat{\theta}, \theta_0) \right\} \quad (18.88)$$

When  $n \rightarrow \infty$  (and therefore  $\hat{\theta} \rightarrow \theta_0$ ) still the contribution of the residual term becomes negligible. Concerning the term with second order derivatives, it converges in probability to the information matrix  $\Im(\theta_0)$  (18.87), while some suitable form of the Central Limit Theorem (CLT) ensures that

$$\frac{1}{\sqrt{n}} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta_0} \xrightarrow[n \rightarrow \infty]{distr} N[0, \Im(\theta_0)] \quad (18.89)$$

thus, from (18.88) and (18.89) we get

$$\sqrt{n}(\hat{\theta} - \theta_0) \xrightarrow[n \rightarrow \infty]{distr} N[0, \Im(\theta_0)^{-1}] \quad (18.90)$$

## 18.4 Maximum Likelihood: estimation of the (asymptotic) variance-covariance matrix

The practical consequence of (18.90) is that, when  $n$  is large enough,  $\sqrt{n}(\hat{\theta} - \theta_0)$  has approximately a normal distribution with zero mean and  $\Im(\theta_0)^{-1}$  variance-covariance matrix. Thus  $(\hat{\theta} - \theta_0)$  has approximately a normal distribution with zero mean and  $\Im(\theta_0)^{-1}/n$  variance-covariance matrix, that is

$$\hat{\theta} \text{ approx. } \sim N[\theta_0, \Im(\theta_0)^{-1}/n]$$

Practical estimation of the information matrix can be done in two different ways, using the sample analogues of the *expectations* on the right hand sides of (18.74) or (18.77): each expectation is replaced by the sample average, and derivatives are computed at  $\hat{\theta}$

1. Hessian estimator of  $\Im = \frac{1}{n} \sum_{i=1}^n \left[ -\frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} \right]_{\hat{\theta}} = \frac{1}{n} \left[ -\frac{\partial^2 \ln L(x, \theta)}{\partial \theta \partial \theta'} \right]_{\hat{\theta}}$
2. Outer Product estimator of  $\Im = \frac{1}{n} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \frac{\partial \ln f(x_i, \theta)}{\partial \theta'} \right]_{\hat{\theta}}$

As a consequence, also the practical estimation of the variance-covariance matrix of  $\hat{\theta}$  can be done in two different ways: using the Hessian or using the Outer Product matrix

1.  $\widehat{Var}(\hat{\theta}) = (H)^{-1} = \left[ -\frac{\partial^2 \ln L(x, \theta)}{\partial \theta \partial \theta'} \right]_{\hat{\theta}}^{-1}$
2.  $\widehat{Var}(\hat{\theta}) = (OP)^{-1} = \left\{ \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \frac{\partial \ln f(x_i, \theta)}{\partial \theta'} \right]_{\hat{\theta}} \right\}^{-1}$

## 18.5 Misspecification, Pseudo-Likelihood and “sandwich matrix” (simplified proof)

The sample  $x_1, x_2, \dots, x_n, \dots$  is made of independent draws from the same population. We believe that the density of each  $x_i$  belongs to the *family* of density functions  $f(x_i, \theta)$ , so we build the *presumed* likelihood and maximize it, obtaining  $\hat{\theta}$ . However, it may happen that the density of the r.v. does not belong to the *family* of density functions  $f(x_i, \theta)$ , so our *presumed* likelihood is in fact misspecified: it will be called *pseudo-likelihood* or *quasi-likelihood*, and the derivative of the logarithm will be called *pseudo-score*. The *integral* (18.72) is still zero, but for no value of  $\theta$  such an integral can be considered the expectation of the pseudo-score, as  $f(x_i, \theta)$  is not the density of  $x_i$ .

We assume that the *true* density of  $x_i$  belongs to a regular (but *unknown*) family of density functions  $g(x_i, \theta)$ , and we still call  $\theta_0$  the *true* parameter value. Unlike (18.73), the expectation of the pseudo-score in  $\theta_0$  can be nonzero

$$E \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta_0} = \int \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \Big|_{\theta_0} g(x_i, \theta_0) dx \neq 0 \quad (18.91)$$

It may happen that the expectation is zero if evaluated at a different value of the parameter (vector): such a value,  $\theta^*$ , is called *pseudo-true-value*

$$E \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta^*} = 0 \quad (18.92)$$

Performing analogously to (18.86) the Taylor expansion with initial value  $\theta^*$  rather than  $\theta_0$

$$\frac{1}{n} \frac{\partial \ln L(x, \theta)}{\partial \theta} = \frac{1}{n} \sum_{i=1}^n \frac{\partial \ln f(x_i, \theta)}{\partial \theta} = \frac{1}{n} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta^*} + \frac{1}{n} \sum_{i=1}^n \left[ \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} \right]_{\theta^*} (\theta - \theta^*) + \frac{1}{n} \sum_{i=1}^n Res(x_i, \theta, \theta^*) \quad (18.93)$$

and then computing it at  $\hat{\theta}$ , the left hand side is zero. Multiplying by  $\sqrt{n}$  we get

$$\sqrt{n}(\hat{\theta} - \theta^*) = \left[ -\frac{1}{n} \sum_{i=1}^n \frac{\partial^2 \ln f(x_i, \theta)}{\partial \theta \partial \theta'} \right]_{\theta^*}^{-1} \left\{ \frac{1}{\sqrt{n}} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta^*} + \frac{1}{\sqrt{n}} \sum_{i=1}^n Res(x_i, \hat{\theta}, \theta^*) \right\} \quad (18.94)$$

We still assume (without proof) that, under suitable regularity conditions, when  $n \rightarrow \infty$  the contribution of the residual term becomes negligible. As in section (18.3), we first apply (some suitable form of) the Law of Large Numbers to the term with second order derivatives, whose probability limit will be a constant matrix (let's call  $A$ ). Then we apply (some suitable form of) the Central Limit Theorem to the term with first order derivatives, each of which has expected value zero (according to 18.92), and call  $B$  the variance-covariance matrix of the asymptotic normal distribution

$$\frac{1}{\sqrt{n}} \sum_{i=1}^n \left[ \frac{\partial \ln f(x_i, \theta)}{\partial \theta} \right]_{\theta^*} \xrightarrow[n \rightarrow \infty]{distr} N[0, B] \quad (18.95)$$

thus

$$\sqrt{n}(\hat{\theta} - \theta^*) \xrightarrow[n \rightarrow \infty]{distr} N[0, A^{-1}BA^{-1}]$$

While in section (18.3)  $A$  and  $B$  were both equal to the information matrix, here they can be different. The asymptotic variance-covariance matrix  $A^{-1}BA^{-1}$  can be called *sandwich* matrix. An obvious way of estimating  $A$  and  $B$  is to use the Hessian and the matrix of outer products, respectively. Thus, practical estimation of the variance-covariance matrix of  $\hat{\theta}$  can be done as

$$\widehat{Var}(\hat{\theta}) = H^{-1} OP H^{-1} \quad (18.96)$$

with the same expressions for  $H$  and  $OP$  as in section (18.4). This expression provides a *robust* estimator of the variance-covariance matrix of the pseudo-maximum-likelihood parameters  $\hat{\theta}$ .

## 18.6 Linear regression model with normal error terms: maximum likelihood and ordinary least squares

With the usual symbols, let the model and the vector of parameters be

$$y = X\beta + u \quad u \sim N(0, \sigma^2 I_n) \quad \theta = \begin{bmatrix} \beta \\ \sigma^2 \end{bmatrix}$$

Being the Jacobian of the transformation  $\partial u_i / \partial y_i = 1$  (so that the density  $f(y_i, \theta) = f(u_i, \theta)$ ) the log-likelihood is

$$\ln L(y, \theta) = -\frac{n}{2} \ln(2\pi) - \frac{n}{2} \ln(\sigma^2) - \frac{1}{2\sigma^2} (y - X\beta)'(y - X\beta)$$

the score is

$$\frac{\partial \ln L(y, \theta)}{\partial \theta} = \begin{bmatrix} \frac{\partial \ln L}{\partial \beta} \\ \frac{\partial \ln L}{\partial \sigma^2} \end{bmatrix} = \begin{bmatrix} -\frac{1}{\sigma^2} (X'X\beta - X'y) \\ -\frac{n}{2\sigma^2} + \frac{1}{2\sigma^4} (y - X\beta)'(y - X\beta) \end{bmatrix}$$

the Hessian matrix is

$$H(\theta) = \frac{\partial^2 \ln L(y, \theta)}{\partial \theta \partial \theta'} = \begin{bmatrix} -\frac{1}{\sigma^2} X'X & \frac{1}{\sigma^4} (X'X\beta - X'y) \\ \frac{1}{\sigma^4} (X'X\beta - X'y)' & \frac{n}{2\sigma^4} - \frac{1}{\sigma^6} (y - X\beta)'(y - X\beta) \end{bmatrix} \quad (18.97)$$

The expectation of the off-diagonal blocks of the Hessian matrix is zero, and the expectation of the last block is  $n/(2\sigma^4) - (1/\sigma^6)n\sigma^2 = -n/(2\sigma^4)$ . So, the information matrix is

$$n\mathfrak{I}(\theta) = E[-H(\theta)] = \begin{bmatrix} \frac{1}{\sigma^2} X'X & 0 \\ 0 & \frac{n}{2\sigma^4} \end{bmatrix}$$

and its inverse (the Cramér-Rao bound for the covariance matrix of any unbiased estimator) is

$$[n\mathfrak{I}(\theta)]^{-1} = \begin{bmatrix} \sigma^2 (X'X)^{-1} & 0 \\ 0 & \frac{2\sigma^4}{n} \end{bmatrix}$$

The covariance matrix of coefficients estimated by OLS is  $(X'X)^{-1}\sigma^2$ , so OLS coefficients attain the Cramér-Rao bound. But the OLS estimator of  $\sigma^2$  does not attain the bound. In fact, remembering that  $\hat{\sigma}^2/\sigma^2$  is a random variable  $\chi_{n-k}^2$  divided by  $n-k$ , and that the variance of the  $\chi_{n-k}^2$  is  $2(n-k)$ , we get:

$$V(\hat{\sigma}^2) = \left[ \frac{\sigma^2}{n-k} \right]^2 V(\chi_{n-k}^2) = \frac{2\sigma^4}{n-k}$$

which is larger than the Cramér-Rao bound (however, it is not possible to find an unbiased estimator of  $\sigma^2$  with a smaller variance; see Rao, 1973, 5a.2).

*Remark.* If the Hessian (18.97) is *estimated*, that is it is computed at the OLS estimated parameters  $\hat{\beta}$  and  $\hat{\sigma}^2$ , the off diagonal blocks are zero ( $X'X\hat{\beta} - X'y = -X'\hat{u} = 0$ ).

*Remark.* Obviously, the *good* properties of the OLS estimator just described are no more valid if some elements of  $x_i$  are correlated with  $u_i$ . In principle, the likelihood should be re-specified, to take explicitly into account the correlation, and maximum likelihood would be different from the simple OLS estimator.

## 18.7 Nonlinear regression model: maximum likelihood and nonlinear least squares

Let the model and the vector of parameters be

$$y_i = q(x_i, \beta) + u_i \quad u_i \text{ i.i.d. } N(0, \sigma^2) \quad i = 1, 2, \dots, n \quad \theta = \begin{bmatrix} \beta \\ \sigma^2 \end{bmatrix} \quad (18.98)$$

where  $q$  is a nonlinear function of the explanatory variables  $x_i$  and of the coefficients  $\beta$ , satisfying some *regularity* conditions (continuity and differentiability). Almost all properties of the linear regression with normal errors apply to the nonlinear regression as well. The only difference is that, unlike the linear case, estimation of coefficients usually requires the application of a numerical technique (e.g. Newton-Raphson or similar), as it cannot be done in closed form.

Being the Jacobian of the transformation  $\partial u_i / \partial y_i = 1$  (so that the density  $f(y_i, \theta) = f(u_i, \theta)$ ) the log-likelihood is

$$\ln L(y, \theta) = -\frac{n}{2} \ln(2\pi) - \frac{n}{2} \ln(\sigma^2) - \frac{1}{2\sigma^2} \sum_{i=1}^n [y_i - q(x_i, \beta)]^2 \quad (18.99)$$

the score is

$$\frac{\partial \ln L(y, \theta)}{\partial \theta} = \begin{bmatrix} \frac{\partial \ln L}{\partial \beta} \\ \frac{\partial \ln L}{\partial \sigma^2} \end{bmatrix} = \begin{bmatrix} \frac{1}{\sigma^2} \sum_{i=1}^n [y_i - q(x_i, \beta)] \frac{\partial q(x_i, \beta)}{\partial \beta} \\ -\frac{n}{2\sigma^2} + \frac{1}{2\sigma^4} \sum_{i=1}^n [y_i - q(x_i, \beta)]^2 \end{bmatrix} \quad (18.100)$$

thus the system of first order conditions is

$$\begin{cases} \frac{1}{\sigma^2} \sum_{i=1}^n [y_i - q(x_i, \beta)] \frac{\partial q(x_i, \beta)}{\partial \beta} = 0 \\ -\frac{n}{2\sigma^2} + \frac{1}{2\sigma^4} \sum_{i=1}^n [y_i - q(x_i, \beta)]^2 = 0 \end{cases} \quad (18.101)$$

Solution of the last equation gives

$$\sigma^2 = \frac{1}{n} \sum_{i=1}^n [y_i - q(x_i, \beta)]^2 \quad (18.102)$$

that can be substituted into (18.99) producing the *concentrated* log-likelihood

$$\ln L(y, \beta) = -\frac{n}{2} \ln(2\pi) - \frac{n}{2} - \frac{n}{2} \ln \left\{ \frac{1}{n} \sum_{i=1}^n [y_i - q(x_i, \beta)]^2 \right\} \quad (18.103)$$

There is no more the parameter  $\sigma^2$ , so the concentrated log-likelihood has to be maximized only with respect to the coefficients  $\beta$ . From equation (18.103) it is clear that the maximum of the concentrated log-likelihood is the minimum of the sum of squared errors  $[y_i - q(x_i, \beta)]^2$ ; thus maximum likelihood is *nonlinear least squares*.

After  $\beta$  has been estimated minimizing (with some numerical technique) the sum of squared errors, the estimate of  $\sigma^2$  is obtained from (18.102); it is the average of the squared residuals, analogously to the linear regression case.

*Remark.* Rather than minimizing the sum of squared residuals, one could minimize “ $n/2 \ln$  of the average of the squared residuals” (as in equation 18.103), using the Newton-Raphson procedure (at least in the last iterations). The coefficient estimates would obviously be the same, but there would be no need of any further calculation to estimate the variance-covariance matrix of the coefficients: it would simply be the inverse of the last iteration’s Hessian matrix.

However, from a computational viewpoint, convergence of the Newton-Raphson procedure is usually faster when the method is applied to the sum of squared residuals. Thus, it might be more convenient to split the procedure in two parts: first compute coefficients minimizing the sum of squared residuals; then, when convergence has been achieved, compute (and invert) the Hessian of “ $n/2 \ln$  of the average of the squared residuals” as an estimate of the coefficients variance-covariance matrix.

## 18.8 Nonlinear regression model with autocorrelated errors

We consider the same case as (18.98) when the error terms have a stationary AR(1) structure

$$y_t = q(x_t, \beta) + u_t \quad u_t = \rho u_{t-1} + \varepsilon_t \quad \varepsilon_t \text{ i.i.d. } N(0, \sigma^2) \quad t = 2, \dots, n \quad (18.104)$$

where the vector of parameters is

$$\theta = \begin{bmatrix} \beta \\ \rho \\ \sigma^2 \end{bmatrix} \quad |\rho| < 1 \quad \text{Var}(u_t) = \frac{\sigma^2}{1 - \rho^2} \quad (18.105)$$

Subtracting from (18.104) its lagged value, we get

$$y_t - \rho y_{t-1} = q(x_t, \beta) - \rho q(x_{t-1}, \beta) + \varepsilon_t \quad \varepsilon_t \text{ i.i.d. } N(0, \sigma^2) \quad t = 2, \dots, n \quad (18.106)$$

that can be treated as a nonlinear regression model with *i.i.d.* normal errors. Thus, to maximize the concentrated log-likelihood with respect to the coefficients ( $\beta$  and  $\rho$ ), one has to minimize the sum of squared errors of the transformed model (18.106)

$$\sum_{t=1}^n \{ [y_t - \rho y_{t-1}] - [q(x_t, \beta) - \rho q(x_{t-1}, \beta)] \}^2 \quad (18.107)$$

After  $\hat{\beta}$  and  $\hat{\rho}$  have been computed from minimization of (18.107), the estimate  $\hat{\sigma}^2$  is obtained, as usual, as the average of the squared residuals of (18.106).

*Remark.* The same argument of the previous section can be applied here as well. Rather than minimizing the sum of squared residuals (18.107), one could minimize “ $n/2 \ln$  of the average of the squared residuals” using the Newton-Raphson procedure. This would produce the same estimates of  $\beta$  and  $\rho$ , and the estimate of their variance-covariance matrix would be the inverse of the last iteration’s Hessian matrix. From a computational viewpoint, however, it is usually more convenient to first compute the estimates of  $\beta$  and  $\rho$ ; then, after convergence of the iterative maximization procedure has been achieved, compute (and invert) the Hessian of “ $n/2 \ln$  of the average of the squared residuals” as an estimate of the coefficients variance-covariance matrix.

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